CONSULTING ASSISTANCE ON ECONOMIC REFORM II

DISCUSSION PAPERS

The objectives of the Consulting Assistance on Economic Reform (CAER II) project are to contribute to broad-based and sustainable economic growth; and to improve the policy reform content of USAID assistance activities that aim to strengthen markets in recipient countries. Services are provided by the Harvard Institute for International Development (HIID) and its subcontractors. Funded by the U.S. Agency for International Development (Contracts PCE-0405-C-00-5015-00 and PCE-0405-Q-00-5016-00), it gives A.I.D.'s missions and Washington offices access to economists and other social scientists with extensive practical experience who are highly regarded within their professional disciplines. Some of the CAER work generates results of interest to a broad audience. The CAER discussion papers series provides a convenient and consistent form in which to share these results.

Fiscal Decentralization: A Methodology for Case Studies

George M. Guess
William Loehr
Jorge Martinez-Vazquez

CAER II Discussion Paper No. 3
May, 1997

The views and interpretations in these papers are those of the authors and should not be attributed to the Agency for International Development, the Harvard Institute for International Development, or CAER II subcontractors.

For information contact:
CAER Project Manager
Harvard Institute for International Development
One Eliot Street
Cambridge, MA 02138, USA
Tel: (617) 495-9776; Fax: (617) 495-0527

TABLE OF CONTENTS

LIST OF TABLES AND FIGURES

EXECUTIVE SUMMARY

The terms of reference for this project call for the development of a methodology for doing case studies of fiscal decentralization in developing countries and the countries of Eastern Europe (EE). While the terms of reference do not call for actually doing case studies at this stage, they call for the use of country examples to illustrate either the importance of the issues raised or as examples of how the methodological guidelines may be applied. Other objectives specified in the scope of work are:

- To improve understanding of the relationships between fiscal decentralization (FD), the efficient use of public funds, economic growth and democracy.

- To provide guidelines that USAID economists can use in analyzing and recommending appropriate fiscal mechanisms at different levels of government.

Practical limitations are imposed by the time available for this project in the face of the enormous volume of literature, both theoretical and empirical, that is available on the subject of fiscal decentralization (FD). Our approach is to concentrate on the methodological guidance that the literature provides. We have placed priority on methodologies that emphasize analyzing "appropriate fiscal mechanisms."

Economic theory provides no straightforward guide to what the relationships are between FD and growth (or economic development). Without theoretical guidance no comprehensive empirical tests can be done, and indeed, none exist. Furthermore, in no country is the process of FD "finished." Rather, the forms that FD takes, and its evolution in each country, are conditioned by the effects that FD has had in the past and by the evolution of economic and political forces in each country where FD has been a major concern. The unfinished nature of FD in any country also reflects the fact that the design of FD involves the balancing of conflicting objectives and that these objectives get different priorities as government regimes and public opinion change over time. History also provides many constraints. What is important is how changes in FD affect changes in economic variables associated with economic development. It is the process by which FD affects other variables that is important to understand. Therefore, as we develop guidelines for case studies we will be exploring the evolution of FD in developing and transitional countries and describing the ways that evolution has been linked to changes in economic development.

There is no single, or even simple measure of the degree of FD. FD is so multidimensional that specification of a formal hypothesis for statistical testing would require stepping down from a view of the general picture, to a level which provides only a narrow slice of the panorama. Thus, one is not likely to be able to compare the experience of countries only on the basis of empirical hypothesis testing, except when dealing with narrowly defined technical issues, such as legal delegation of authority to local government mayors. In providing guidance for the case studies there can be no "cookie cutter" approach applicable for comparison of country experiences.

The main focus of our methodology is to describe the process of decentralization and to identify similar sets of questions to be put to countries under study. Many of the questions are open-ended. When dealing with fiscal decentralization, the range of institutional arrangements, and the multiple objectives of policy are so varied that some open-ended questions are needed to accommodate the variety of concerns about FD. These questions are presented because based on our field experiences and from the literature review, they are most important for gaining a comprehensive view of the FD process. However, when the time comes to answer the big question, is a country better off for having decentralized some or all aspects of its fiscal affairs, judgement is required. One simply cannot force the decentralization experience into a narrowly defined test of whether a country is better off or not. The fundamental reason for this "test indeterminacy" is the multiplicity of economic and political objectives associated with FD and the non-existence of a unique or absolute way to weigh them. This indeterminacy does not mean that FD can always be judged as both "good" and "bad." There is no "best" degree of FD for all countries or even any particular country over time. Again, judgment is required in the context of each separate country. The methodological issues for case studies that are examined here are designed to make that judgement easier. They are not designed to eliminate the need to make such judgements.

The proposed case study approach focuses on the process of decentralization. During the process of decentralization we expect the simultaneous occurrence of economic concerns, such as giving local government tax and borrowing power and guaranteeing macroeconomic stability at the national level. The simultaneously occurring phenomena have both positive and negative aspects. Therefore, our methodological approach focuses on the application of appropriate fiscal rules and appropriate fiscal mechanisms for achieving the potential benefits of FD, while minimizing the likelihood of negative consequences. An "appropriate fiscal rule," or an "appropriate fiscal mechanism," is one which raises the probability, or likelihood, of improving efficiency while simultaneously avoiding adverse impacts on macro stability or unfavorable distributional changes. Normative rules are more general than mechanisms. Rules specify general principles by which fiscal affairs should be organized. Mechanisms are specific steps, tools, or institutional arrangements that can be brought to bear to implement rules. Not all rules have predetermined mechanisms to apply. In some cases a rule is either satisfied or it is not, and no specific mechanism is called for.

In performing the cases studies, observations should be made on how well the case has applied the rules and used the mechanisms suggested in the text. From this one can identify probable reasons why a case has been particularly successful or why it has failed. Also, if the objective for the case study is to identify policy interventions, by examining the application of the rules and mechanisms, one can identify weaknesses in the FD process that may be amenable to policy changes. Finally, by applying a fairly standard set of questions about rules and mechanisms, one can compare cases. One should be able to identify why some cases are more successful than others.

We have focussed our inquiry on four major economic characteristics, or dimensions of FD, each of which imply positive or negative outcomes from FD. The four dimensions are not entirely exhaustive but they cover almost all major economic concerns with FD. Each of the dimensions is complex, and all come into play simultaneously in any consideration of FD policy. One cannot pursue fiscal decentralization without confronting these four factors. Therefore, all policy decisions regarding FD have to deal with these four issues simultaneously. These are:

1. Economic efficiency which is defined as both getting greater "value for money" from public expenditures for taxpayers and getting greater amounts of output from given resources. These two aspects of economic efficiency are known as "consumer efficiency" and "producer efficiency." In the definition of the latter,"greater output" can mean improved quality output. Efficiency improvements are unambiguously an economic benefit. Efficiency improvements depend in turn on the proper design of six factors:

- Expenditure assignment
- Revenue assignment

- Fiscal Transfers
- Fiscal management and budgeting
- Legal structures
- Democratic Institutions

2. Inequality across regions can be a result of fiscal decentralization unless measures are taken to prevent it or ameliorate it. Some local jurisdictions will simply be better able to fend for themselves than others. If regional inequalities are exacerbated by fiscal decentralization to intolerable or undesirable levels, it is a negative consequence.

3. Macro-economic stability may be threatened by poorly designed fiscal decentralization, and it is also a negative consequence.

4. Regional competition will result from the natural process of jurisdictions trying to improve their lots by attracting more private resources and investment and public projects and better public resources. Regional competition may be positive as when it forces local governments to operate more efficiently, for example, to attract private investors, or negative, as when local jurisdictions engage in "negative-sum" practices, for example, attempting to export local taxes to other jurisdictions.

In the main part of the report, (Section Three) appropriate rules and mechanisms are identified which are aimed at maximizing the positive and minimizing the negative consequences on these four dimensions of FD.

The process of fiscal decentralization has to address the four factors mentioned above. Their prioritization depends on government values and objectives and on individual country institutional constraints. An example of priorities that is representative of many countries choices in the past and that may also reflect significant consensus among experts in the field is as follows:

1. Ensure macro-economic stability,
2. Improve economic efficiency,
3. Assign functional responsibilities to local governments,
4. Provide horizontal balance at least to a point where all local government units are capable of providing minimum basic services.
5. Enhance positive regional competition

Finally, the ability of countries to decentralize their fiscal affairs will depend upon historical and institutional forces that affect collective values and decision-making options. These are discussed in Section Five.

SECTION ONE
INTRODUCTION

The terms of reference for this project call for the development of a methodology for conducting case studies of fiscal decentralization in developing countries and the countries of Eastern Europe (EE). The terms of reference do not call for doing case studies, but do call for using country examples to illustrate either the importance of the issues raised or as examples of how the methodological suggestions may be applied. Other objectives specified in the scope of work are to:

- Improve understanding of the relationships between fiscal decentralization (FD), economic growth and democracy.

- Provide guidelines that USAID economists can use in analyzing and recommending appropriate fiscal mechanisms at different levels of government.

To provide a coherent technical assistance response for particular country strategies, USAID needs to know how fiscal federalism and fiscal decentralization (FD) relate the economic objectives of efficiency in the allocation of national resources, macroeconomic stability, and growth and development. USAID needs to be able to describe past evolutionary roles of fiscal federalism and fiscal decentralization in particular regions and to predict with some certainty how they should behave in the future in relation to standard economic policy objectives. It is known that in many countries that institutional constraints in the form of restrictive central policies and weaknesses in the design of decentralized systems of public finance have worked against the objectives of efficiency, stability and balanced growth. From this it may be assumed that under certain conditions direct intervention efforts through a formal program to decentralize and improve systems design can help induce efficiency and growth without adding to economic instability.

Practical limitations are imposed by the time available for the project when contrasted against the enormous volume of literature, both theoretical and empirical, on the subject of FD. Our approach is to concentrate on the methodological guidance that the literature provides. Furthermore, to limit our recommendations to reasonable proportions, we have placed priority on methodologies that emphasize analyzing the appropriate fiscal mechanisms mentioned above. We believe that in the end, USAID officials are forced by the nature of their assignments to focus on the practical issues surrounding fiscal mechanisms. We also believe that in so doing they gain the understanding of the relationships between FD, economic efficiency, stability and growth which is also called for. Finally, in a meeting with USAID (October 9, 1996) it was determined that a full scale consideration of the relationships between FD and democracy was not practical given the resources constraints of this project. Nevertheless, in Section Three, we examine democracy as a subfactor on which FD efficiency depends. In short, to the extent possible, when consideration of democratic institutions can be brought into the analysis, they will be.

IS THERE A CASE AGAINST FISCAL DECENTRALIZATION?

Much of the literature, and many donor-assisted programs in developing and transition economies presume that fiscal decentralization is always a good thing. One should keep in mind that this is not a foregone conclusion. The case against fiscal decentralization (or for fiscal centralization) may be stronger in transitional and developing societies than in industrial countries. Three main arguments have been used against decentralization: (a) that it may harm stabilization, (b) that it may slow down economic growth, and (c) that it may negatively affect regional equity.

First, it is said that to ensure economic stabilization, the central government should control the main tax and borrowing instruments. For example, delegation of economic stabilizer functions to subnational units (e.g. the personal income tax or social security benefits through block grants), would risk severing the link between automatic stabilizers and cyclical fluctuations in the economic system. Similarly, excessive borrowing and inability to pay contracted debts by subnational units can threaten the fiscal position of the national treasury. Recognition of local debt obligations increases the consolidated fiscal deficit and diminishes national control over the budget which may lead to inflationary policies.

Second, maintenance of coherent growth policy is an additional argument for centralization. Investment capital is scarce. In order, to maximize returns and prevent local governments from competing with the central government for tax resources, it is said that the national government in developing and transitional economies should retain controls over all economic resources including those for local investments.

Third, it is argued that centralization can reduce regional inequities and fiscal disparities which would be caused otherwise by granting autonomous taxing powers to subnational governments. Disparities in wealth and income may be accentuated by FD, for example, as wealthier urban governments can benefit from their greater taxation powers and higher tax bases. Another cost of decentralization is interjurisdictional competition for people, jobs and investment which may not always be in the interest of the national economy.

All three are serious concerns which should be kept in mind when providing technical assistance advice to developing countries and economies in transition on FD strategies. However, more than making a case for centralization, these three concerns make a strong case for careful design and implementation of FD once a country embarks on this strategy. Achieving the goals of greater economic efficiency, deeper representative democracy and other benefits of FD may not be worthwhile if that leads a country to macroeconomic instability, lower or negative economic growth and unbearable fiscal disparities across LGUs.

But independently of the theoretical merits and demerits of FD, the process of decentralization also responds to concrete political realities. In early stages of transition, and in many developing countries, governments are faced with the dilemma that the central administration is overloaded and cannot provide all services. Stabilization and redistribution policies are obvious central government responsibilities. There is considerable pressure to assign LGUs the responsibility to provide many services even when LGUs are not administratively capable of performing their allocation function. At the LGU level, revenue collection, regulation, personnel, procurement and licensing systems have normally not been established; official skills are still lacking and in many cases central controls have not yet been dismantled. Strapped for cash and facing growing local demands for improved service quality, central governments are increasingly incapable of delivering what should be local services. Yet they perceive that for political and macroeconomic reasons they cannot devolve them to subnational units either. Needed is a strategy for FD that is based on sound theoretical principles and grounded in practical comparative experiences of other countries. Such a strategy will lower the political costs and increase economic benefits of fiscal decentralization for transitional and developing societies.

The rest of the report is organized as follows. In the following section we discuss how case studies may be used to gain insights into the "how" and "how not to" implement FD. This section offers recommendations on how to conduct case studies. Section Three describes the main characteristics of FD rules for the general design of intergovernmental fiscal relations and the mechanisms that may be used to operationalize these rules. Section Four places the economic characteristics of FD in the setting of developing and transitional countries, and addresses the different experiences with the process of FD. Experience with FD is so varied and the conditions facing any real countries are so different that one must carefully consider constraints and opportunities before one can gain an understanding of any real case of FD.

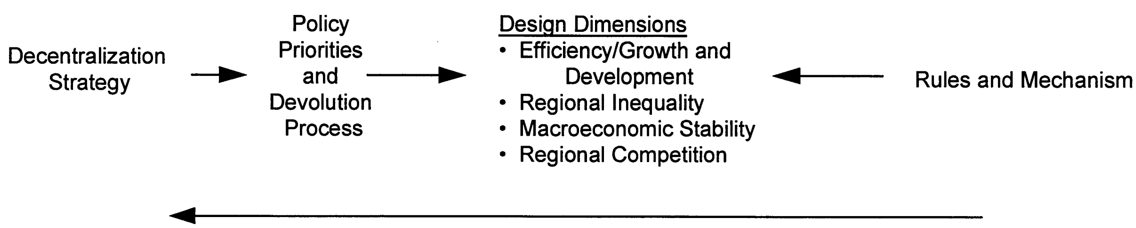
Section Five describes how case studies may be put in context by considering institutional and historical factors, and Section Six discusses the comparability of case studies across countries.

SECTION TWO
CASE STUDY APPROACH

The main task of this report is to develop a methodology for conducting case studies. This methodological framework aims at providing an understanding of the interrelationships among the building blocks of FD and particularly what linkages may exist between FD and overall policy objectives such as increased democratization or economic growth and development (See Figure 1).

FIGURE 1

FISCAL DECENTRALIZATION DESIGN



Economic theory provides no straightforward guide to what the relationships are between FD and growth and economic development. Without theoretical guidance it is hard to devise comprehensive empirical tests, and indeed, very few exist (1). Relevant data are so scarce and so imprecise that formal hypothesis testing is often inconclusive. There is no single, or even simple measure of the degree of fiscal decentralization. Fiscal decentralization is so multidimensional that specification of a formal hypothesis for statistical testing requires stepping down from a view of the general picture, to a level which provides only a narrow slice of the panorama. Thus, one is not likely to be able to compare the experience of countries only on the basis of empirical hypothesis testing, except when dealing with narrowly defined issues.

The scarcity of empirical tests is partially attributable to the evolutionary nature of FD and to the power of many other intervening variables that simultaneously affect economic growth and democracy. FD implies institutional changes which affect a great number of economic/political factors, but which have their impact over a prolonged period. The experience with FD in Eastern Europe (EE) and many developing countries is new and most impacts of FD are indirect and occur far in the future. As FD occurs, other factors that have a more immediate impact on growth and development are likely to occur. Changes in investment, international market conditions, major changes in political regime, all intervene to obscure the unique impact of FD. Thus, in most cases one cannot relate empirically the ultimate impact of FD with recent changes in FD. The most one can hope for is to relate changes in FD with changes in fiscal behavior and other macroeconomic variables, and to imply what future conditions will result. Indeed, design of FD policies requires considerable judgment which is guided only partially by economic theory.

The literature suggests that long-term growth rates are a function of such variables as: development, economic freedom, savings rates, investment behavior, human capital, educational levels, degree of competition, smaller government consumption and other factors. It has been noted that those countries that are boldest in taming inflation also grow the fastest. The relationship between fiscal decentralization and growth therefore may not be direct. That relationship is also obscured by a complex interaction of other, perhaps stronger variables. On the other hand, the development and quality of life in areas where most people live (in towns and cities) is affected by the authority and ability of LGUs to provide services. These in turn are linked to properly assigned functions and to revenue assignment and fiscal transfer systems. For example, assignment of land titling functions to municipalities and provision of credit functions to local banks can help reduce landholding inequality. Since income inequality impedes growth, strengthening this component of FD can improve chances of local and regional economic growth and development. Many other indirect connections between growth and FD can be made. In addition, the conventional measurement of economic growth may not capture all the consumer and producer efficiencies that may come with FD. An expenditure of $100,000 by local governments may result in greater welfare for citizens than an equal amount spent by the central government. And yet conventional measures of growth will treat both expenditures the same.

Concern with economic growth per se can be misplaced and/or overemphasized. Growth is so strongly affected by factors other than FD, that any effect FD has can be swamped by the others. Surely, one can link FD to growth in a variety of theoretical ways, but a concern with growth per se does not seem to have been the main factor motivating host country FD policies or the programs of USAID and other donors. What does seem to have motivated them is a concern for something like "economic development." Economic development, while difficult to define, generally includes economic growth, but it may include other changes as well (see Loehr and Powelson, 1981). Economic development may be thought of as a generalized economic improvement in a society, which may occur even in the absence of economic growth. Often, what is sought by proponents of FD is an economic "improvement," even if there is no direct, measurable impact on economic growth. An economic improvement can be defined as a change that leaves someone better off, without implying a deterioration in the well-being of any one else. More and better public services may be provided with an equal, or even a lower amount of fiscal resources. As illustrated in the previous paragraph, improvement could come from a fairer distribution of fiscal resources across geographic areas in a country. To describe how these, and other improvements occur is part of this report's task.

There are several approaches to connecting fiscal decentralization to growth and to the other elements of economic development. The connection between growth and FD is made primarily through theoretical inductive reasoning. A direct empirical connection is not available in most cases and the work done so far in the literature is not reliable (1). However, the main reason for pursuing FD is to increase efficiency in the use of fiscal resources. If FD improves upon efficiency, then increased output flows from given resources, and growth is a likely result. The theoretical links between FD and improved efficiency are well explored in the literature. Indeed, they are the main focus of most of the economic literature. Until very recent tests on the existence of direct links between FD and growth, the literature on FD has always relied on the indirect link between growth and decentralization through economic efficiency. Therefore, our approach to the FD/growth link is to focus on the improving efficiency/FD link, from which improved growth is implied. The other elements of economic development can often be explored empirically. Many of these elements are also a reflection of greater economic efficiency. These elements often boil down to whether FD results in more or better education, whether health care has improved, whether roads are repaired, and so forth. In general, where empirical work is practical and leads to applied policy solutions, it should be used; where it is not an inductive approach can be used.

Centralization/decentralization is not a single continuum. There are many aspects of a country's fiscal affairs that can be more or less decentralized. Since fiscal affairs can be divided into many activities, centralization/decentralization takes place along a number of continua. Often it is not possible to say that one country is more decentralized than another, since they may be decentralized on some dimensions but not on others. One may compare decentralization on limited fiscal dimensions, such as expenditures at the local level versus the central level, leading to conclusions, for example, that country A has a more decentralized approach to providing primary education than country B. But, one may be very hard pressed to say that fiscal affairs in country A are more decentralized than they are in country B in any general sense. For example, even if expenditures are larger at the local level in country A, local governments in country B may have a larger share of their own revenue financing more decisions on how local expenditures are implemented. Thus, case studies cannot deal with simple yes/no answers except on narrowly defined sub-dimensions of fiscal organization. There is no single model of fiscal decentralization or set of measures that can be applied across the board to all countries.

Fiscal decentralization takes many forms and is therefore not amenable to standardized "cookie cutter" types of analysis. The concept reflects a cluster of laws, policies, and decrees that emanate from the central government and/or parliaments which affect local autonomy. In Eastern Europe and Latin America, local autonomy is normally a grant of authority from the center. This tends to be a characteristic of unitary (political) systems of government. The most decentralized systems **devolve** authority to sub-national units to design, implement and finance services with their own-source revenues. Devolution also allows LGUs to determine their own mix of services, unimpeded by centrally-mandated expenditures or legally pre-empted areas. In the middle of the FD scale are **delegations** of authority to provide specific services according to central standards, such as social assistance and education. At the other end of the scale, **deconcentrated** services are provided through regional and/or local units of the central government. Deconcentration and "administrative decentralization" are similar. Under a deconcentrated system LGUs have no independence to determine what services are provided, nor how they are provided. They have no power to redirect revenues. Deconcentrated services do not allow development of local administrative expertise. Nor are there usually any incentives for own-source revenue generation to finance such services. Thus, based on some combination of geographic location, history and tradition, internal politics (often partisan) and external influences (such as EU standards, and reactions to international donor advice and conditions), each country represents a mix of decentralized programs and services. FD profile cases indicate that devolution and delegation of authority are more often associated with improved growth and development than is the case with deconcentrated authority.

For an effective FD strategy and policy, the sequence of functional deconcentration and delegation is important. Improperly sequenced and coordinated measures can destroy the intended effect of FD. For example, in Albania, mayors cannot enforce laws against illegal building construction because policing is a central function. The lack of local police to enforce tax regulations are also constraints to local autonomy in Bangladesh and Nicaragua. Police power and law enforcement are needed by mayors to enforce land use and property rights within local jurisdictions and to enforce local taxes. Without such authority, investors fear loss of property rights to squatters; investors cannot receive restitution or accountability from local officials in disputes; and mayors are afraid of collecting taxes from adverse possessors because this can create a claim to the property against the lawful owner. Thus, improperly sequenced decentralization, can work against the efficacy of local service delivery.

In no country is the process of FD "finished." Rather, the forms that FD takes, and its evolution in each country, are conditioned by the effects that FD has had in the past and by the evolution of economic and political forces at the present time. History provides many constraints. But, as has been explained by Peterson (1996) it is the process by which FD affects other variables that is important to understand. This is particularly important for EE. FD in EE is so new that few of the final impacts that FD is expected to make can be observed. It is still too soon to "know" what FD has wrought. Therefore, as we develop case studies we will be exploring the evolution of FD and the way that evolution has been linked to changes in economic development.

A discussion of the relationship between FD and economic development, which includes economic growth is our main focus, but other variables are at play as well. FD brings with it a set of economic changes which have their impact simultaneously. Within that set of changes some are positive and others negative in terms of their impact on economic growth and development. These are addressed in Section Three below. The design of FD systems needs to balance these factors to get a desirable outcome. Where positives outweigh negatives, economic improvement (growth and development) are likely to occur. Those preferred FD policies are those that maximize the positives and minimize the negatives.

The main focus of our methodology is to describe the process of decentralization and to pose similar sets of questions to countries under study. Many of these are open-ended questions. As we have noted, when dealing with fiscal decentralization, the range of institutional arrangements, and the multiple objectives of policy are so varied that only open-ended questions can accommodate the variety of concerns about FD in any number of countries. These questions have been presented because in our experience and in the literature, they are most important for gaining a comprehensive view of the FD process. The literature has much to offer. As stated by Shah (1991a) "...much useful guidance in the design of intergovernmental fiscal relations in developing and transition (economies) is available from the theoretical and practical literature on fiscal federalism. It is also apparent ... that very few developing countries have paid any serious attention to this guidance..."

In performing cases studies, four kinds of observations should be made by the writers. First they should examine how well the case has applied the rules and used the mechanisms suggested in the next section. Again, rules specify general principles by which fiscal affairs should be organized. Mechanisms are specific steps, tools or institutional arrangements that can be brought to bear to implement rules. Not all rules have predetermined mechanisms to apply. In some cases a rule is either satisfied or it is not, and no specific mechanism is called for. Second, from this case writers should be able to identify probable reasons why a case has been particularly successful or why it has failed. Third, if the reason for the case study is to identify policy interventions, by examining the application of the rules and mechanisms, case writers should be able to identify weaknesses in the FD process that may be amenable to policy changes. Finally, by applying a fairly standard set of questions about rules and mechanisms, the writers can compare cases, and identify why some cases are more successful than others.

SECTION THREE
MAIN FEATURES OF FISCAL DECENTRALIZATION DESIGN

The four dimensions are quite comprehensive in that they cover almost all major economic objectives which may be implemented by FD design (2). Each of the dimensions is complex, and all come into play simultaneously in any consideration of FD policy. Therefore, all policy decisions regarding FD have to deal with these four issues simultaneously:

- Efficiency
- Inequality across regions
- Macro-economic stability
- Inter-regional competition

The main questions any case study has to deal with are whether policy interventions in these areas maximize (or at least raise) the probability of gains and minimize (or reduce) the probability of losses associated with FD. Again, these categories are very broad, so most of our important observations and policy recommendations can be grouped under one of them.

Throughout the discussion we will be using the terms "subnational governments," "local governments" and "tiers of government" somewhat interchangeably. As a shorthand we will also use the term LGU (for "local governmental unit"). At a conceptual level in the context of specific case studies these terms get defined more precisely by specific situations. Levels of government can take many forms, as for example in federal systems versus decentralized unitary governments. In a federal system, decentralization takes a "polycentric approach" (see Bird, 1994 and Ostrom, Schroeder, and Wynne, 1992) where governments exist on a multi-level hierarchy following pre-determined rules. In a unitary system, decentralization follows a "superior authority" principle.

The analysis of each of the four economic dimensions of FD design below will provide rules that must be obeyed and appropriate mechanisms to help implement those rules. In what follows we will be classifying rules and mechanisms under specific categories. However, there are some general rules that should guide the design of intergovernmental fiscal relations across the board.

Rules on the general design of intergovernmental fiscal relations:

1. **Autonomy.** LGUs should be independent in setting their own expenditure priorities and in varying, at least at the margin, the overall level of funding .

2. **Revenue adequacy.** LGUs should have revenues available to meet their obligations at adequate levels of provision.

3. **Equity.** Funds made available to LGUs should vary positively with need factors and inversely with their own capacity to tax.

4. **Predictability.** LGUs should be able to predict the revenues available to them, either from their own sources, from taxes shared with the central government, or from transfers.

5. **Resource Allocation.** For efficiency purposes, the way in which revenues are received from the central government should be generally neutral relative to the LGU allocation of resources to different sectors or kinds of activity.

6. **Simplicity.** Revenue sharing schemes should be as simple and transparent as possible. There should be no reward for "grantsmanship."

7. **Incentives.** Good management and efficient practices should be rewarded.

8. **Safeguards for grantors objectives.** A grantor (normally the central government) should be able to impose safeguards that the objectives of categorical grants are met, via monitoring, joint progress reviews, technical assistance and other means.

EFFICIENCY

The main effect of FD is to provide improved resource allocation and therefore improved efficiency. Improved efficiency is the main positive factor to come from FD. This is the classic effect described Musgrave (1959) and by Oates (1972) and is the main impact sought by FD. Efficiency gains rest on the presumption that local governments are much better in identifying and fulfilling the needs of households, since they are closer to them, and in mobilizing and using local resources to pay for goods and services having purely local impacts (Peterson, 1996). When locally provided goods and services "spill over" to the wider community, the case for FD weakens (Bird, 1994) but is not destroyed unless benefits spill over evenly to the entire nation. An important element often forgotten in FD design is that the costs of local goods and service provision should be paid for by the beneficiaries to reap maximum efficiency gains.

Improved efficiency is defined as getting greater consumer (taxpayer) welfare from fixed resources. If FD yields greater output from given resources then economic growth is implied by successful FD. However, not all gains in consumer welfare can be measured as increases in output. Because the contribution of the public sector to national output is measured by the cost of public expenditures, many gains in welfare escape conventional measures of output growth. Using fiscal resources in a way that households find more useful and beneficial increases welfare, but this does not necessarily increase output. When FD is successful, resources have been reallocated so that marginal costs of publicly provided goods and services more closely match marginal benefits. Some of the design elements necessary to maximize the likelihood of an efficient resource reallocation from FD follow.

Expenditure Assignment

By expenditure assignment, we mean the determination of which public expenditure functions will be performed by each level of government. It must be clear which expenditure responsibilities are assigned to local government, which to regional governments (if an intermediate level exists), which to the central government, and which are to be shared. For some functions, responsibilities are shared. In these cases, the assignment of expenditure responsibilities must be clear about sharing arrangements. Considerations of expenditure assignment logically precede revenue assignment, since the latter is at least in part guided by the former. This logical sequence often is not respected. In the early years of the transition, the Russian Federation focused almost exclusively on revenue assignments, which had to be arranged continuously because of shifting expenditure responsibilities (Martinez-Vazquez, 1994b). In the past decade, many Latin American countries implemented FD reforms by transferring revenues to local governments without the corresponding reassignment of expenditure responsibilities (Peterson, 1996). In determining which expenditures are to be assigned to a LGU, the "decentralization theorem" (Oates, 1972) should be applied:

> *Rule: Each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs.*

Another version of this rule is known as the "principle of subsidiarity" used, for example, in the European Charter of Local Governments. This principle or rule states that public expenditure functions must be assigned to the lowest possible level of government that is competent to implement them.

The "decentralization theorem" rule should be modified under restricted conditions:

Rule: Centralization is justified only where 1) there are impediments to mobility of people from one jurisdiction to another, 2) spillovers are significant 3) economies of scale are present and 4) administrative and compliance costs are excessively high at the local level.

The task of a case study on expenditure assignment is to determine if the decentralization theorem is being applied. One must examine the expenditure categories assigned to each level of government. Then, where centralization is chosen over assigning expenditures to LGUs, one must ask whether centralization is justified by Oates' four criteria. If the decentralization theorem is not being applied and/or the assignments to central government are not justified, then it is likely that greater efficiency could be gained by reassigning expenditures.

It should be noted that the existence of modifying conditions, such as spillovers or external economies and economies of scale in production, does not always call for the centralization of service provision. It is possible to achieve an efficient provision of these services at the local level with other types of interventions. For example, economies of scale can be harnessed at the local level by connecting the service delivery with a private provider or by having several LGUs cooperate together, such as in the case of a multi-jurisdictional water and sewerage system. Likewise, the impact of spillovers or external economies can be controlled by appropriate central government transfers or by having LGUs cooperate in special districts.

Other policy questions on expenditure assignment to be asked in a case study are:

- Is there an explicit assignment of expenditure responsibilities in the law? Where? In the Constitution (not very desirable), in the central (federal) government budget law, in a local government budget law, or in any other document? What type of legal document? The more permanent the expenditure assignments are, the better. Therefore, a local government law, which makes expenditure assignment explicit is preferred. The Baltic countries (Estonia, Latvia, and Lithuania) have approved local government laws that contain explicit assignments of expenditure responsibilities (Martinez-Vazquez and Borx, 1995b).

- Is the de facto assignment of expenditures the same as the de jure assignment? One of the most frequent assignment problems is that actual expenditure assignments do not match what is specified in the law. Is the law being applied in fact? In Bangladesh, India, Vietnam and Central American countries, local governments often perform only a few of the functions assigned de jure to them.

- The clearer the expenditure responsibilities are the better. Have the expenditure responsibilities been stable in the recent past or are they constantly changing?

- What is the assignment of capital expenditure responsibilities? Do subnational governments at the second tier (often states or provinces) invest in infrastructure for which they have responsibility in operation and maintenance (O&M)? What about third tier of government (LGUs) or is investment concentrated in only at the center? Matching investment responsibility with the beneficiaries of the investment and with O&M responsibility is an important determinant of the sustainability of capital investment projects. The poor state of maintenance of capital infrastructure in Eastern Europe and in developing countries can be traced back to split responsibilities for construction and O&M.

- How are unfunded mandates dealt with? (There should not be any)

- Especially in the cases of Eastern Europe, divestiture of social expenditure responsibilities by enterprises is an important expenditure issue. What is the status of divestiture in a country under study? Has the process run its course? Have there been explicit policies to address this issue?

Revenue Assignment

Revenue assignment logically follows expenditure assignment. Revenues for LGUs can come from only two sources. Either, local governments have their own sources of revenue from taxes and/or user fees, or they receive revenue which is transferred to them from the central government. These revenues can take the form of tax-sharing or outright transfers. The task of revenue assignment is one of creating an appropriate mix of revenue sources, while allowing LGUs to cover the expenses of expenditures that have been assigned to them.

In determining revenue assignments to LGUs one should keep in mind the principle of correspondence. Perfect correspondence is where the marginal costs of providing public services equals the marginal benefits from those services for the people receiving the services at each level of government. The correspondence principle implies that local governments have taxes reserved for them that fall exclusively on their citizens and which cannot be transferred to the citizens of other jurisdictions. (See Lopez-Murphy, 1996)

The correspondence principle can only be applied by approximation. The main problem is that the marginal benefits from public expenditures cannot be observed and the marginal costs may not be obvious. The conditions for equating marginal costs and benefits are probably best approximated by allowing local citizens to decide which public services to provide and how much of them to provide, combined with local ability to independently control some of its own tax base and tax rates. Efficiency gains from FD result from a closer match between the marginal benefits from public expenditure and the marginal costs. Indeed, this is the classical argument for fiscal decentralization. To make this match, LGUs should be required to pay for some of the services they provide out of locally raised revenue, over which they have some control. In this way as LGUs adjust the services that they provide, they also imply cost consequences for their constituencies. This increases political accountability and responsiveness of local public officials to the needs and preferences of their constituents.

Rule: Local governmental units should have assigned to them some sources of revenue which derive from their own constituents. Within limits, LGUs should have control over tax rates and tax bases (of their own taxes).

How independent the local authorities are to vary rates or change a tax base is a matter of efficient tax policy design. Local power to change a tax base, with the possible exception of the property tax, in most cases would be a negative factor because it may lead to predatory tax exporting efforts, counterproductive competition and complexity for taxpayers. In cases where the impact of the tax is purely local, discretion to change the tax base should be permitted, for in those cases there is a clear connection between local expenditures and tax burden. The independent power to change the tax rate (on a given base) may be a positive factor depending on the tax. Local ability to change the rate on the property tax would normally be a positive factor, but changing the rate on the personal income tax, and perhaps on the corporate income tax may be a positive factor only in cases where the economic activity being taxed originates in the locality. Independent ability to change the rate on the VAT would be very negative since proceeds from the VAT cannot be directly associated with regional activity. The VAT should never be allocated to subnational governments. Brazil offers a good example of all the problems that arise from crediting and debiting VAT across subnational jurisdictions. Retail sales taxes at the local level can be used if there is not a national VAT. Two countries that have local sales taxes with a national VAT, Canada and Nicaragua, have been considering their elimination. The problem with local sales taxes is that it can lead to undesirable cascading effects. Excise taxes at the local level are feasible but they cannot deviate much across jurisdictions.

The level of revenue autonomy granted to LGUs varies considerably among countries. The less developed the system of FD the lower the level of revenue autonomy. The Albanian case is one of minimal revenue autonomy. At the other extreme are federal systems such as the U.S. where there is practically no restriction on subnational revenue autonomy (other than the Commerce Clause). Central control of local revenue bases and rates is a common feature of FD in unitary systems of government as it is for example in the Balkan countries of Albania and Macedonia and also in most developing countries.

In deciding to assign certain taxes and/or tax bases to LGU's, central governments must decide on their own priorities. Priorities which are most often singled out by central governments include focusing on: (a) economic efficiency, (b) income inequality, or (c) macro-economic control. In most cases, central governments should keep control of those taxes that are critical for macro-economic stability and for maintaining some direction in income distribution. (Bahl, 1994) Central governments normally retain control of progressive income taxes, corporate income taxes, capital gains, indirect taxes on luxury goods payroll taxes that are supported by payroll deductions, VAT and customs duties. Local governments should be assigned taxes whose burdens do not extend beyond the boundaries of the localities. Local sales taxes, property taxes and user fees are normally assigned to LGUs. Some typical tax assignments are suggested by Table 1.

These lists of taxes would differ in particular countries. For example, individual income taxes are the most significant sources of revenues in Scandinavian countries and a few other Western European countries. Property taxes are the most important source of local revenues in decentralized systems with an Anglo-Saxon tradition. Many developing countries, including those in Latin America have assigned property taxes at the local level. The property tax is perhaps the most difficult tax to administer fairly and it shows consistently in taxpayer's polls as the most unpopular. Therefore, even though this is a tax that on theoretical principles should be assigned to the local level, in practice it may present significant problems for a fast-moving FD strategy. Countries in transition in Eastern Europe are beginning to introduce property taxes at the local level but their significance will be small at least until local markets develop and titling and private ownership institutions are in place.

User charges and impact fees are good sources of revenues for LGUs but often remain underused, especially in developing countries. In transition countries in Eastern Europe, there was very little tradition for charging households for local services and only now are local governments starting to use them. Another often unused source of revenue are impact fees or betterment taxes. These can be charged by local governments as a one-time assessment on the owners of property for street improvements (e.g. paving of roads, lighting) or access to service (e.g. water and sewerage lines). Only a few developing countries in Latin America (Colombia, Venezuela) have made any significant use of this tax. It is common among developing countries and those in Eastern Europe to use a long list of small "nuisance" taxes and licenses. Often the revenues raised with these minor taxes and fees do not justify the administrative and compliance costs imposed on local residents.

TABLE 1
TYPICAL REVENUE ASSIGNMENTS BY LEVEL OF GOVERNMENT

Central Government taxes:	Value-Added tax (VAT) Individual income tax Corporate income tax Natural resource taxes Customs duties Export duties
State, Regional or Large City:	Individual income tax Surcharges on national taxes Retail sales tax Excise taxes Property Tax Vehicle taxes
Local:	Property tax Vehicle taxes User charges Licenses and fees

Source: Bahl, 1994

Typically most LGUs cannot provide all assigned services from their own revenue sources. The logic behind assigning expenditures to LGUs is totally different from the logic that assigns taxes to LGU's. It is not very likely that revenues and expenditures match after assignments are finished. The theory and practice of FD have many expenditures assigned to local levels but relatively few significant taxes. The FD literature has measured this mismatch between expenditure responsibilities and own-source revenues through the compilation of "vertical imbalance" indices (Hunter, 1994). The most typical of these indices measures what percent of total local expenditures are financed by local own revenues. Most developing countries and Eastern European countries achieve a low, often minimal score, vis-a-vis decentralized developed countries. However, even decentralized developed countries are far from experiencing 100 percent own-source revenue sufficiency.

Besides the assignment of taxes and fees as own-source revenues to LGUs, it is quite common for central governments to share revenues from specific taxes or all central government revenue collections with LGUs. Revenue-sharing for specific taxes (e.g. the individual income or corporate income tax) is done on a derivation basis. This means that LGUs are entitled to a percentage of specific tax revenues, and that the central government tax administration collects within the boundaries of the LGU jurisdiction. This type of arrangement is quite common in countries in transition in Eastern Europe. The sharing of a fixed percentage of all central government tax revenues is not done on a derivation basis but rather through use of a distribution or apportionment formula. This arrangement has become quite popular in Latin American countries over the past decade. The nature of tax sharing arrangements is somewhere between that of tax assignment and pure transfers. In the case of sharing of particular taxes, there is an element of tax assignment because revenues accrue to LGUs on a derivation basis. But there is also an element of pure transfer because the LGU has no control over the rate, base or even the sharing rate. The case of sharing of all central government revenues is more in the nature of pure transfer than tax assignment.

Revenue tax sharing arrangements are much less effective than pure revenue assignments in promoting effective FD. Nevertheless, they are used and can provide adequate financing for LGUs. However, not all taxes are created equally for revenue sharing. Some national taxes should never be used for revenue sharing on a derivation basis.

Rule: For revenue assignment candidates, the following hierarchy applies:

- Property and personal income taxes connect well to local economic activity and therefore are the best candidates for revenue sharing.
- Excises on a destination basis also connect well to local economic activity, but the connection may be weaker. Therefore, sharing excise taxes should occur after sharing of property and personal income tax revenues.
- Corporate income taxes are not so good for revenue sharing because the economic activity giving rise to corporate tax revenues is likely to be spread across many local jurisdictions. There would be an apportionment problem and calculating shares would be administratively messy.
- VAT would be a very poor candidate for revenue sharing because of the crediting and debiting among different sub-national jurisdictions and therefore VAT should never be used for revenue sharing.

Once the candidate taxes for revenue sharing on a derivation basis are determined, sharing arrangements should provide the stability and predictability in revenues that LGUs need. The sharing of the entire pool of central government revenues or part of these revenues require the use of distribution formulae. Setting the pool of revenues to be shared can be done in the Constitution or in the annual budget of the central government. The first approach has the positive element of certainty but it may be too inflexible vis-a-vis the discretion needed by the central government to formulate fiscal policy. Over the last decade, many Latin American countries have used their Constitutions to fix the pool of funds to be distributed to LGUs. Most countries in transition with general revenue sharing arrangements fix the pool of funds in the central government's annual budget. Once a pool of funds is determined, a variety of formulae can be used to distribute the funds among LGUs.

There are two basic approaches to creating tax sharing formulae. First, one can apply expenditure norms for each of the services that are expected to be supplied by LGUs. Norms can be calculated on the basis of services needed and maximum costs per unit for each service. Summing across all LGU services can give the total revenue required. This method has the disadvantage of being very data intensive and time consuming. Costing local public services is also difficult because the quality or level of services that is adequate is hard to establish or reach consensus on. Second, one can look for a statistically-based formula that links revenue required with "need." For example, revenue needed may be made a function of each LGU's population, per capita income age distribution and other similar variables. When creating formulas of this type it is important to include some consideration of the LGU capacity to raise revenue on its own. Clearly, the form of a revenue sharing formula can vary widely, but generally:

Mechanism: Some relatively set formula should be established for revenue sharing which relates revenue to be shared with LGU needs and fiscal capacity.

There are two main goals of general revenue sharing formulae: First, they should be designed to close the vertical imbalance or mismatch between expenditure objectives of local governments and the resources available to them. Second, they should distribute these funds in an equitable way. This latter objective is accomplished by including measures of need and fiscal capacity in the sharing formulae. Expenditure needs are relatively easy to proxy. However, fiscal capacity is difficult to measure. Revenues collected from own-sources is not a good measure of fiscal capacity because their performance responds to both fiscal capacity (availability and size of tax bases) and to fiscal effort (the effectiveness and willingness to enforce taxes). Because of these difficulties, often it is not possible to incorporate fiscal capacity in sharing formulae.

A different but related issue is whether to incorporate in the sharing formulae some measure of LGU fiscal effort. A common problem among developing countries is that LGUs appear to exert little effort in raising their own taxes (e.g. property taxes and user fees). Sharing formulae can be used to encourage local tax effort. However, thereafter, in principle the system should not encourage or discourage tax effort.

Colombia and Chile illustrate the use of formulas that are related to local needs. In Colombia, before 1993 transfers were in no way related to poverty. At best, transfers were neutral; at worst regressive with respect to GDP per capita. (Sanche and Gutierrez, 1995:211) Law 60 of 1993 changed the basis for transfers in favor of a formula designed to emphasize "need." In 1993, municipalities received 15 percent of the nation's current revenues. This was to increase to 22 percent by 2001. Transfers to municipalities were to be distributed by the formula:

- 40 percent in direct relationship with the number of people with unmet basic needs;
- 20 percent in direct proportion to a poverty index, when compared to national averages;
- 22 percent in direct proportion to population; and
- 18 percent as a function of fiscal efficiency in the municipality and progress in improving the quality of life.

While one could quibble with the definitions of the driving variables in the transfer formula, the point remains that the formula is designed to emphasize fiscal "need" and to reward favorable performance.

In Chile, transfers to regions are made through the Fund for Regional Development (FDNR), which accounted for 55% of the regional funding from the central government and 11% of central government spending in 1992. Transfers made through the FDNR were made by the formula:

- 90 percent as a function of a poverty index. The index is composed of 12 components such as infant mortality rate, percentage of regional population living in extreme poverty, health indicators and so forth.

- 5 percent as a function of regional government fiscal efficiency, where efficiency is defined in terms of the percentage of disbursements in line with the budgetary framework of the previous year, ability to stick to a budget and so forth.

- 5 percent for emergencies.

Regardless of the shares and form revenue sharing takes, it is important that it provides certainty and stability for LGUs. Without them, LGUs cannot plan and budget their expenditures efficiently.

Rule: Revenues assigned to local governmental units should be reasonably stable and predictable.

After three years of constant changes in revenue sharing arrangements, the Russian Federation introduced in 1994 the provision that sharing arrangements could not be changed for a period of three years. In the Philippines, the Local Government Code of 1991 specified transfers that the central government is required to make to LGUs. Most important of these is the "internal revenue allotment," IRA, which is a fixed

40% of central government revenues, from non-natural-resource-based sources, lagged three fiscal years. That is, the FY 1996 IRA is 40% of nominal central government revenues from three years ago (Miller, 1996:8). In addition, LGUs receive 40% of central government revenues associated with natural resource extraction in the LGU's territory, lagged one year. These formulas make forecasting fairly easy for about a three year period because the base for sharing is already known with a three-year lag. Unfortunately, forecasts of real revenue to be shared by LGUs also require a forecast of inflation. However, even in a moderate inflation case like the Philippines, the forecasting effort is greatly simplified by application of this simple formula.

In many countries, especially countries in transition to market economies, the assignment of revenues has not been predictable. Rather, the revenues available to each LGU are often negotiated annually (or even more frequently) with central authorities. In Kazakstan, Kyrgystan and Ukraine, shared revenues are negotiated yearly, but even this does not end the process. As a fiscal year progresses, some LGU deficits begin to appear and these in turn are covered by further ad hoc negotiations to shift revenues from the center to LGUs. For comparative purposes, Albanian cities receive 95% of their funding from informal negotiated transfers/shared tax bases, while Polish cities receive only 55.5% from these sources. Own-source revenues are only 2.5% in Albania; 25.7% in Poland; with a 40% EU average. Thus, in cases such as Albania, cities have only minimal sources of revenue over which they have control. Since negotiated settlements may vary, year to year, or as in the case of many former Soviet republics even within a year, there are two main factors that damage the search for maximum efficiency:

First, LGUs are unable to forecast resources available in the future, and therefore cannot plan for long-term service delivery. Second, and perhaps most important, the link between expenditures and costs can be broken. If revenue from central government sources is negotiated annually, then central government sources can become the marginal source of revenue, and the link between marginal costs and expenditures at the local level is broken. Absence of predictable revenues for a 12-month budget period creates a disincentive for LGU officials to determine the costs of each service and to drive them down through innovative management. Time spent on remaking the budget (because in fact it is not annual) drives out efforts to deliver efficient services.

It is often observed that revenue assignments in practice are much different than they are de jure. LGUs may not receive budgeted transfers from the central government, or tax revenues assigned to them but collected in their behalf by tax offices of the central government. Release of actual transfers may vary from those budgeted for such reasons as revenue shortfalls at the center, incapacity of LGUs to apply for budgeted funds, or simply distribution of political rewards and punishments by the central regime. Release of funds collected by district tax offices for LGUs may be more difficult to ascertain where LGUs do not receive regular reports on each revenue source. The ability of LGU's to enforce the delivery of revenues that have been assigned to them is often very limited by poorly developed legal systems. Often LGUs may not be entirely knowledgeable of their rights. Central governments may use the excuse of unforeseen expenditures or national disasters to stop payment of several installments of revenue sharing. This occurred during 1996, for example, in Bangladesh and Nicaragua. Courts may be overburdened, politically motivated or simply incompetent to help LGUs. Where reliance on courts is difficult, legal ambiguities can be arbitrated and differences interpreted by a joint parliamentary-executive branch oversight committee. This was done in the Philippines in 1991 to interpret the 1991 Local Government Code that mandated substantial power to LGUs. In other cases there is little hope for FD until a legal basis for enforcement is found.

Rule: In addition to being clear, revenue assignments need to be enforceable. Functional assignments of police power need to precede or accompany revenue assignments.

Institutional Mechanism: An independent judiciary, subdivided into local units including tax courts, needs the power to adjudicate disputes between tiers of government. LGU officials at each level must have sufficient administrative discretion and budgetary authority (e.g. appointment of police chiefs) to enforce local laws and contract claims. Alternatively, the government can establish a Grants Commission as an independent agency with powers to arbitrate disputes between the central and local governments. This is a model introduced by Australia that has been imitated.

There is no single best way to create a revenue assignment system that will fit all circumstances and accomplish all desirable goals. Whether or not a choice is a good one depends on the objectives of the central government. Bahl (1994:140) has offered several guidelines for evaluating alternative revenue assignment arrangements.

- Expenditure assignments should drive the assignment of revenues. One needs a full understanding of the budgetary consequences of the expenditures that have been assigned.

- If the primary objective is efficiency, then the central government must be willing to delegate some taxing power to LGUs.

- If an important goal is equity, then grants from the central government should play an important assignment function, and grant formulas should focus on indicators of the elements of inequality that the central government wants to emphasize.

- If macro-economic stability is an overriding concern, then central governments will not be able to assign as much revenue to LGUs as in countries where macro stability is well in hand.

Revenue Transfers from the Central Government

A distinction needs to be drawn between "revenue assignments" and "revenue transfers." Revenue assignments are automatic, and something to which the LGUs have a right. Revenue transfers by contrast may occur in addition to assignments. LGUs have no automatic right to transfers. As we have seen, somewhere in between with varying characteristics of revenue assignment and transfers lies revenue sharing. Transfers make up for differences that remain between revenues and expenditures after the assignment mechanism runs its course. Transfers may also induce LGUs to take on responsibilities that they may be unwilling or unable to undertake without transfers. Transfers of revenues from the central government to LGUs weaken the linkage between costs and benefits discussed above. If this correspondence is broken, then many of the efficiency benefits of FD may be lost. If transfers are extremely high then local tax efforts are undermined. Nevertheless, some discretionary transfers of central government revenue to local governments will likely be necessary, in addition to the revenue assignments discussed above.

Rule: A system of intergovernmental transfers based on objective and transparent needs to be in place to accomplish several needed features of FD.

Transfers are used for several reasons:

1. **Closing vertical imbalances.** The bases for expenditure and revenue assignments are different and there is no guarantee that expenditures and revenues will match. Expenditures are assigned on the basis of the decentralization theorem. Revenues are assigned on the basis of taxes available at the local level and those that are shared.

2. **Spillovers or external economies may exist.** Expenditures in one LGU may have significant spillovers for other LGUs, or the nation overall. Without transfers, the service in question could be under-supplied.

3. **Equity considerations across LGUs** may require additional transfers to make up for differential fiscal gaps across LGUs, differences in net fiscal benefits, and/or to meet national equity objectives.

4. **Minimum standards of service may not be guaranteed in all LGUs without fiscal transfers.** These may be relevant in cases where minimum standards are desirable from a national perspective, e.g., in education, health care, pensions, etc.

5. **Transfers** may be needed as direct payments or reimbursement for services rendered by LGUs in lieu of the central government.

Mechanisms: Grants of different types can be designed for transfers to LGUs. The following is a list of general kinds of grants and the circumstances under which they might be used.

1. **Unconditional non-matching grants.** These supplement the budgets of LGUs without distorting relative "prices" of public services. Thus, the LGU has little incentive to adjust the mix of services offered. Unconditional non-matching grants (or block grants) may increase LGU spending by less than the amount of the grant since local tax effort can decline, replacing locally derived revenues with revenues from the grant.

2. **"Selective" or "conditional" non-matching grants.** These are designed specifically to distort relative prices so that LGUs spend relatively more on the favored activities. Again, local tax effort may decline as grant funds are substituted for locally-raised revenues.

3. **Selective matching grants.** These distort relative prices so that increased spending on favored activities occurs. Because of the matching feature, significant substitution of grant funds for locally-raised revenue is minimized.

4. **Open-ended, matching grants.** Grants can be spent for any purpose, and local tax effort is encouraged. These are most justified where local expenditures give rise to large spillovers in favor of the country at large. These type of grants can lead to runaway fiscal obligations and should be used sparingly or not at all.

5. **Closed-ended matching grants.** This is similar to #4 but with limits on the overall size of the grant.

In assessing the appropriateness of the grant mechanism, several limitations of the grants should be kept in mind. Matching grants cannot make up for inadequate or uneven fiscal capacities. Some jurisdictions may simply not be able to make the match. General non-matching grants are preferred if the objectives are to enhance welfare of local residents in areas that are too weak to raise revenues on their own and to increase local autonomy or discretion over expenditures. Open-ended selective matching grants are most suitable in inducing increased spending on a favored activity because of interjurisdictional spillovers (e.g. water and sewerage systems) or the social merits of the expenditures (e.g. education and health) (See Shah, 1991a). In practice in developing countries, one finds few of the possible kinds of grants. Most frequently one finds general, non-matching transfers, or selective grants to fill a fiscal gap. Other types of transfers are rare.

Policy questions that should be asked in case studies include:

- Is there a system of equalization transfers? Is there equalization of revenues alone or of both revenues and expenditures? Is this based on formulas or on "negotiation"? If based on formulas, what are they? Are local shares driven by objective criteria or are they arbitrary and/or driven by negotiation? How equalizing are the payments? Is equalization effective at the second and third tiers of government or only at the second tier?

- Do systems of transfers from the central government pay any attention to LGU fiscal capacity? In most cases they do not, though they should. Increases in transfers should try to avoid reduced tax efforts at the local level.

- Are there programs of equalization transfers that are aimed at specific standards of performance. Most often there are not, though there should be.

- Is there a matching grant program? Is the program only for capital projects or is it for social expenditures as well?

- Are there direct payments to sub-national governments by the central government in compensation for mandates and direct central government services provided through the local governments?

- Are transfers for purposes that "internalize" local externalities?

Fiscal Management

Fiscal management and budgeting capabilities need to be in place. Efficiency at the local level both in the sense of cost minimization, and responsiveness and accountability to taxpayers requires local budgeting and fiscal management capacities. This is one of several institutional and process areas where the relationship between FD and results is likely to be iterative: improvements in internal fiscal management lead to greater capacity and receptivity of the central government to greater FD, followed by additional improvements in budget formulation, execution, audit and evaluation. Local fiscal management capacity is necessary for a sustainable FD. Without such capacity, FD systems are at risk of losing fiscal control. LGUs will lack incentives to retain or use knowledge; they will not build local creditworthiness capacity and will fail to persuade central officials that FD is indeed feasible.

The fiscal management dimension of FD is typically ignored in policy studies of FD. This practice may be warranted for the case of developed countries because the implicit assumption that appropriate fiscal management systems are in place is probably correct. However, budgeting processes and institutions and fiscal management in general in developing countries and Eastern European countries in transition are generally weak and deficient.

In these countries, budget laws are often deficient in stimulating the development of local management capabilities and may even contribute to weakening or restraining local capacity to plan and administer expenditures. Typical deficiencies in the law include:

First, central government budget law typically does not specify a formal LGU budget process. This is the case in, for example, Vietnam, Bangladesh, and Nicaragua. In other countries , only a calendar of events is specified, such as in Albania. However, in some transitional countries as the Russian Federation, Estonia and Latvia there are explicit laws for the budget process at the subnational level. Often, the central organic law delegates authority for LGU development of its own process. But this is by no means the general rule. Eastern European parliaments often promulgate special laws for capital cities. The 1990 Law on Self-Government of the Capital City delegated substantial budgetary authority to Budapest (Ebel and Simon, 1995:122). But for most non-capital cities in Eastern Europe typically there are still no parliamentary provisions for subsidiary legislation or by-law development, such as for budget processes. This is important in the context of rigid perceptions of legal discretion — LGU officials typically believe that if not commanded it is prohibited. For example, if there is no budget call provision specified in the organic law, implicitly none is required.

Legislators in transitional and developing societies often do not know what is needed for good financial management practice. What does constrain LGU budget practice is the failure of legislators to delegate power to local LGUs to develop their budget processes, specifically local by-laws that specify budget structures tailored to local service and accountability needs (e.g. performance-based budgeting systems) consistent with central treasury interests in preventing uncontrolled expenditures. In many other cases, when powers are delegated, their exercise is limited by regulation and prior approval requirements by central government authorities.

Second, often the annual budgets of LGUs are quite meaningless. In Albania, the central government permits substantial carryover authority of revenue arrears and expenditure obligations. In Bangladesh, LGUs are required to carry forward accumulated tax liabilities. Thus, budgeted revenues and expenditures are occasionally ten times larger than those spent. During the transition, LGUs in Russia and other former Soviet republics operated with nominal budgets that had to be repeatedly revised and repeatedly reduced as central government authorities delayed and amended their own budget. The practice of continuously remaking budgets during the year in the context of fiscal instability and weak skills and systems has been noted for poor countries by Caiden and Wildavsky (1975). These practices discourage local fiscal capacity building and weaken incentives to manage LGU budgets properly.

Third, technical requirements for good budgeting are missing in many developing and Eastern European countries. The classification of expenditures is weak. Budget laws do not make the basic distinction between current outlays which are financed from annual fees and taxes and capital investments that benefit future generations and should be financed through payment of annual debt service obligations. Typically, LGUs cannot issue debt or borrow in most cases and remain dependent upon central largess. The lack of LGU participation in capital expenditures has brought lack of maintenance and "white elephant" projects that local governments may not want and cannot maintain. Few LGUs in developing countries and EE have adequate revenue forecasting capabilities or treasury management capabilities. Most LGUs operate with simple accounts for cash management and single ledger accounting rules for budget execution. Internal audit and control schemes are mostly rudimentary and the practice of external ex-post audit by independent institutions has not yet developed.

Fourth, there are no formal capital planning and evaluation processes, nor are the capital budgets in many developing country and EE LGUs. Thus, without a planning process to smooth out investment expenses, local officials face funding surpluses and shortfalls and are occasionally forced to cover investment needs at the expense of salaries, supplies and maintenance expenditures. The lack of capital budgeting and multiyear planning for capital expenditures often has resulted in both transitional and developing economies in an overhang of unfinished projects and therefore a waste of scarce capital investment resources. a multiyear planning framework of recurrent expenditures is the exception rather than the rule among these countries. The budget laws do not require capital programming and a multiyear budgeting framework largely because legislators are unfamiliar with Western-style budgeting techniques. Officials are often genuinely confused about provisions in the budget law that require annual budgets. Since this seems to contradict multi-year planning and budgeting needs, any provision to this respect is seen as being illegal.

Due in part to the disincentives for learning created by laws which operate to centralize planning and budgeting, there is a general unfamiliarity with budgeting techniques and lack of skills at the LGU level. Almost universally lacking in developing countries and in EE are training institutions dedicated to providing financial management techniques to LGU offices.

Rule: Functioning annual recurrent budgets with clear expenditure classification need to be required of local spending units. The budget execution process and internal control and ex-post audit need to be clearly legislated.

Mechanism: Annual budgets, classified by objects of expenditure should be in place in local governments along with supporting accounting, reporting, control and audit systems. In the longer run, these systems should be converted into performance-based systems that allow managers and accountants to utilize both service performance and accounting data. The performance-based system should be linked to cost of service data, and reported for multi-year periods through accounting codes that are consistent with budget categories. The use of performance approvals should facilitate the audit and evaluation of LGU expenditure programs. Experience from a variety of technical assistance projects shows that LGU officials are receptive to technical assistance in changing budget formats from input to output and its utilization as a management control tool.

An especially difficult area of budgeting in developing and EE countries is that of procurement. If planned procurements from all units are not regularly included in budget plans, overexpenditures can result leading to LGU budget deficits. If procurement procedures are not transparent and internal controls not established, opportunities for corruption can exist. This has been a recurrent problem in countries in transition in part due to the unfamiliarity with conflict of interest regulations. In the Philippines, devolution of procurement to LGUs accompanied by internal control reforms to reduce the number of bureaucratic steps, while increasing the number of officials necessary for particular transaction approvals has resulted in major efficiency gains in cost savings (Miller, 1996). In such countries as Nicaragua or Bangladesh, on the other hand, rigid internal controls can delay transactions and drive up the costs of capital projects. Failure to design expenditure controls properly can result in inefficiencies by restricting the timely flow of funds from LGUs to vendors. Arrears with suppliers sooner or later drive up costs and decrease the quality of services.

Rule: Major gains in technical efficiency (unit cost savings, and cost recovery) and respectability of LGUs may be gained through improvements in public financial management systems, particularly in the functions of procurement and internal control. However, a good balance between fiscal control and management flexibility needs to be found. While control over unapproved outlays are essential, compliance with multiple approvals before outlays may not reduce misappropriation but rather delay legitimate payments to vendors and drive up the costs of service delivery. a major handicap for effective FD in developing countries is the perception that LGUs are corrupt and out of control. Effective internal control and procurement procedures would help dispel that perception.

Mechanism: Devolution of fiscal management functions in procurement and purchasing (which apart from payroll is the major area of LGU outlays) should include reforms in internal control. Such controls should segregate the payments approval stage without creating an apparatus for pre-control of program transactions by accounting and auditing personnel. Ideally, incentives for good fiscal management should rely on tough and enforced penalties after expenditure (gleaned during post-audits).

Ultimately, the failure to delegate authority to design LGU budget processes discourages accountability to local constituents and nullifies any of the advantages of FD. Lack of accountability acts as a constraint on democratic development. As discussed, many developing and transitional countries are in need of technical assistance in all areas of budgeting and fiscal management. But it is important to recognize the limits of technical assistance to improve the efficiency of fiscal management as well as the opportunities in this area. The effectiveness of technical assistance will depend upon the actual devolution or the existence of discretion by LGUs.

It is often argued that because incentives to utilize management tools are lacking where assignments of authority have not been made, broader intergovernmental structural changes should be made before efforts to improve internal management (taxation, accounting, and budgeting). However, incremental management changes are essential in their own right for improvement of service delivery and increased local autonomy. LGU officials in developing and transitional countries have made internal management changes more rapidly where hands-on projects are available. Successful experience with small-scale project planning and implementation has also led to LGU innovations in financing. Albanian and Macedonian LGU technical and fiscal management capacities are being increased through planning and implementation of small local capital projects on a pay-as-you-go basis. There is little question that the efficacy of local autonomy is affected by assignments of revenue and expenditure authority, local administrative and budgeting capacity and the design and functioning of fiscal transfer mechanisms. But despite the fact that in many cases some of these elements are missing, effective internal management improvements can still be made.

Rule: While technical assistance cannot lead to devolution of authority or provision of stable funding sources, provision of concrete project opportunities for the exercise of financial management skills can be accomplished. Small scale public works projects offer the opportunity for LGU officials to exercise management skills and to seek new funding sources.

Mechanism: Projects may serve as the functional equivalent of delegated authority. Small-scale water and sewerage projects financed with seed funding from international donors may encourage LGU officials to learn basic fiscal management skills. This has been the experience in Albania and Macedonia.

Policy questions that should be asked in case studies in the area of fiscal management and budgeting processes include:

- Is there a formal budgeting procedure in place? What is the overall approach to budget formulation? What kinds of budgetary rules are used? Formal annual budgets adopted within clearly specified rules and service objectives are preferred to quarterly or short term incremental rolling budgets (or no budget at all).

- Is there a separate current and capital expenditure budget? Is there a Public Investment Program (PIP) for capital expenditure planning? Is the PIP at both the central and local government levels?

- Is budgeting a single year exercise or does it encompass multiyear expenditure planning? Is there forward budget planning within a medium-term framework?

- Are there adequate local resources, particularly human resources?

- Does revenue forecasting exist, and how effective is it?

- Are financial management practices systems and procedures in place? Is there a treasury function at the subnational level? Is it integrated with the related fiscal functions of: accounting, procurement, cash and debt management, and internal audit? Is there an independent external audit function? By whom?

- How is the tradeoff between flexibility in budget execution and control solved?
- Are there incentives to spend efficiently?
- Is there a program and budget evaluation ex-post? At what level and by whom?
- What safeguards are in place to prevent internal control personnel from becoming involved in pre-control of expenditures?

Legal Structures

A legal system must be in place, that clearly and explicitly specifies the powers and responsibilities of all levels of government. Failure of laws to facilitate professional practice by LGUs in service delivery and to be enforced consistently to protect contract and property rights will diminish efficiency. An important issue in a well-designed FD system is the nature of the laws that give rise to revenue and expenditure assignments. Intergovernmental responsibilities may be defined in constitutions or in individual laws. The constitution is only appropriate for defining general rights and responsibilities of the different levels of government and the relationships among them. Concrete assignments of expenditure responsibilities, revenue sources, budget procedures, and governance institutions are better developed in separate laws. At the LGU level, budgeting and fiscal issues can all be contained in a single or in separate laws. The advantage of a single law is cohesiveness and coordination of these interrelated issues. The disadvantage is that separate technical issues relating to such matters as the tax code and taxpayer rights-obligations are hard to detail in a single document.

Where an independent judiciary exists to interpret intergovernmental authority in particular cases and disputes, keeping revenue and expenditure assignments out of the constitution can be an advantage. Specification of local duties in Latin American constitutions has led to rigidities that inhibit fiscal decentralization. For example, the Brazilian constitution almost dictates bureaucratic inefficiency and fiscal laxity while encouraging an archaic party system that leaves law-making easy prey to special-interests (*Economist*, November 30, p.15). Latin American countries include revenues for specific activities in the constitution. In contrast, the US Constitution assigns broad functions to each tier of government but to prevent institutional paralysis that would stymy growth, it created an independent judicial branch to adjudicate the numerous conflicts over specific issues of commerce, trade and contracts. The Swiss Constitution assigns specific "principal responsibilities" to each layer of government, such as economic order to the Confederation and education, local land planning and law and order to the 23 Cantons. In those unassigned domains such as health and environmental protection, the presumption is in favor of canton responsibility unless federal law assigns functions otherwise (Spahn, 1995:128-129). This allows maximum intergovernmental flexibility within the framework of a written constitutional assignment of functions.

However, precise specification of services by constitutions to particular levels of government, such as water and police to local governments, can lead to inefficiencies. For example, research by Ostrom (1965) on institutional arrangements for water management and for policing (Ostrom, Parks and Whitaker, 1977) indicate that flexibility for interactions at multiple levels of government and through overlapping jurisdictions enables service providers to operate at a scale most efficient for particular activities. Enshrining assignments in constitutions can freeze in responsibilities at the expense of efficient local service delivery. As in the case of LGU budgeting discussed above, needed is a central legal framework that delegates responsibility for translation of broader national law/constitutional service authorizations into locally-relevant by-laws and ordinances for practical implementation.

> *Rule: Laws clearly specifying expenditure responsibilities, revenue sources, and budgeting processes, along with enforcement powers are required. It is normally not advisable that any of these be specified in the country's constitution.*

Policy questions that should be asked in case studies about the legal framework of FD include the following:

- Is there a compiled integrated law or separate but complete laws (e.g.. Law on local self-government, local budget law) or are there many dispersed legal instruments?

- What is the process of amendment of these laws? Do LGUs have any structured input? Is there an association of local governments? What role do they play in the legislative process?

- Are expenditure and taxation rights and responsibilities clear and unambiguous?

Democratic Institutions

To get efficiency improvements, in addition to the elements mentioned above, there needs to be in place some mechanism to convey information about local tastes and preferences. That system is normally consists of democratic processes that allow local people to express their preferences for goods and services and their willingness to pay for them. Democratic institutions, namely, the election of LGU mayors and council members and governors and representatives at the regional level also guarantee responsiveness and accountability by subnational governments to taxpayers/voters. The literature abounds with reference to the inextricable connection between democratic processes and the efficiency benefits from FD. Bird (1994) lists the existence of democratic processes as one of the necessary conditions for efficiency gains through FD. The primary connection between democracy and FD's efficiency gains is that the latter come about when citizens match up marginal benefits from public spending with the marginal costs of providing them. Voting officials in and out of office is the primary mechanism. But other mechanisms are needed to express citizen tastes and preferences about public versus private spending and taxation versus private finance. Referenda (or direct democracy), polls, opinion surveys, and citizens' participation in open council meetings and other participatory institutions provides these mechanisms.

However, FD per se will not induce improvements in democracy. As put by Peterson (1996:18) "Decentralization only provides a framework for governance. It cannot guarantee more effective citizen participation in civic life or higher standards of public accountability." By themselves democratic elections have not so far regulated the behavior of those responsible for managing service delivery. Particularly in Eastern Europe, elections after long-periods of authoritarian rule, absence of traditions of community action and lack of information have inhibited elections from serving as referenda on LGU official performance (World Bank, 1995:6). Democratic institutions need to be legislated separately and explicitly. Nevertheless, the empirical information that has accumulated indicates that citizens tend to trust local governments more than they do central governments. (See Fiszbein, 1995 on Colombia and the surveys in El Salvador referred to by Peterson, 1996). Putnam's (1993) study of Italy shows a high correlation between the effectiveness of local institutions, citizen trust in these institutions and citizen participation. Thus, citizen participation, which is one of the cornerstones of the efficiency gains from FD, can also be an output of the FD process. The fact that FD requires some democratic process to function at all implies a kind of symbiotic relationship between democracy and FD. FD reinforces democracy, and democracy is needed to promote the benefits (i.e. improved efficiency) of FD. The symbiotic reinforcement of both processes is illustrated by Bidus (1995) for the significant advances made in Central American countries in the past five years.

Colombia illustrates the simultaneous development of fiscal decentralization and democratic reform. However, democratic reforms have not always accompanied FD reform. An important roadblock to FD reform in the Central Asian republics of Kazakstan, Kyrgystan and Uzbekistan is that governors of the regions and mayors are appointed by the central government. In Vietnam, the effectiveness of FD reform is questionable due to lack of popular representation.

Citizen participation is a crucial component of effective democracy and FD. As indicated above, citizen participation may come through mechanisms other than local elections. In the U.S. and other Western countries, citizens' participation is institutionalized in referenda and opinion surveys. In EE countries and in most developing countries these institutions do not exist for lack of tradition. For example, Bangladesh city council meetings are never open to the public. However, very significant progress has been made in Latin America. Social fund programs in countries such as Bolivia and Honduras and the similar program of "Solidarity" in Mexico have promoted citizens' participation in governance and also in the implementation of capital investment projects with encouraging results (Peterson, 1996; Campbell, 1991; Bidus, 1995). Another important form of citizen participation relies on NGOs and the interaction of NGOs with local governments.

The realization of the power and effectiveness of NGOs in helping deliver public services may have pushed some governments to formalize relationships. For example, in the Philippines, non-governmental organizations (NGOs) are given a statutory role as members of local planning councils, procurement boards and other governmental entities. (Miller, 1996). NGOs within each district elect their own representatives to the various boards. This has worked imperfectly. Initially there was hostility between NGOs and LGUs. NGOs questioned the competence and motivation of LGU officials, while the latter regarded NGO representatives as unelected (and therefore illegitimate) and in pursuit of an independent agenda. In some jurisdictions the presence of NGOs has proven disruptive; in others they have played an important and positive role. In cases where the devolution process has been threatened, NGOs and local elected officials have generally worked together to protect the process. In Albania and Bangladesh, relations between NGOs and LGUs have often been hostile, though in those cases part of the conflict can be attributed to the extremely weak position of mayors and other local officials. While participation by NGOs can be productive, the record is mixed. There is much to be gained from the cooperation of LGUs with NGOs. But this cooperation should be guided by mutual need and respect among these institutions.

Rule: Social development funds and other similar institutions can be very useful to promote citizens' participation. But they should avoid creation of parallel fiscal management processes at the LGU level. Participatory institutions should strengthen LGU governance units.

INEQUALITY ACROSS REGIONS

FD can bring with it increased inequality across regions as more prosperous regions have greater ability to raise their own revenues or share larger tax bases with the central government and provide more public goods and services. The potential for increased regional inequality under a FD regime is an inherent part of FD and is a negative factor that requires specific attention. Systems must be installed to offset this tendency. The ideal system promotes provision of public goods and services in relatively poor regions, rather than penalize richer regions. Normally, offsetting measures involve some form of equalizing transfer from central governments to local governments. But a lot remains to be done in this area. According to Shah (1994:3) "Despite a high priority in most countries for limiting inter-regional fiscal disparities, no developing or transitional economy has adopted an explicit equalization standard and a fiscal equalization transfer program to disadvantaged subnational governments that takes into consideration their fiscal capacities and the equalization standard in determining entitlements" Since 1994, the Russian Federation has adopted a transfer system for equalizing the needs of the "most disadvantaged regions." Estonia and Latvia also have introduced a form of equalizing transfers. However, these efforts constitute only a first step. The implementation of explicit equalization standards based on need and fiscal capacity have been inhibited by lack of the required data.

Regional inequality may contribute to political support for separatism and may become a constraint to growth and development. It can be argued that significant disparities across regions may lead to demands for more autonomy and secession (e.g. Lombardy in Italy and Catalonia in Spain). The dilemma is that states that withhold from regions and localities the authority to raise local revenues and finance local investment projects may help contain regional inequalities. However, the lack of autonomy may also lead to local terrorist activities and political disaster for central regimes. Authority to elect local officials is necessary but not sufficient to provide local autonomy. a feature of separatist groups in Northern Ireland, and Palestine is that they have capitalized on the lack of funds and authority from their respective central governments. In Spain, significant FD has taken place partly in response to separatist pressure. The model of FD adopted allows for significant differences across regions. Regions where separatist regions are strongest have received much more autonomy in expenditures and revenues. It has been suggested that this non-uniform approach to FD may also be helpful in places such as Russia where there is considerable diversity and strong separatist tendencies. Devolution of fiscal authority permits greater opportunities for local growth, and growth may well reduce popular support for separatism. In this indirect sense, FD can help reduce separatist tendencies.

Regional disparities confront government with one of the most serious challenges in the design of FD systems. Some countries simply ignore the disparities and capitalize on the concentration of resources in the fastest-growing regions (e.g. in China). Other countries ignore LGU government fiscal disparities but concentrate on programs that help more disadvantaged people wherever they live (the U.S. model). Some other countries put in place an equalization system based on transfers from subnational to other subnational governments rather than transfers from the central governments (the fraternal transfer system of Scandinavian countries). Most countries utilize some system of transfers to equalize expenditure needs. Most countries also have regional development policies to encourage industrialization and other objectives that focus on developing the private sector rather than transferring resources to the public sector.

Here are some of the questions that need to be asked about regional disparities in case studies:

- Are there any formal impediments to the free flow of economic resources across regions? Is there an active and separate government policy (separate from decentralization) for regional development of backward areas?

- Is there a system of equalizing transfers? Are transfers rule-based and determined by formula, or are less objective allocation procedures used?

- Is there a fraternal system (or "Robin Hood" system) of funding equalization transfers at the subnational level or are all transfers funded by the central government?

- Is the ability of local governments to raise revenue limited? One concern is that if it is not limited then the potential for increased inequality with FD is high. It may become increasingly difficult for central governments to offset inequality with equalizing transfers.

- What are the disparities in revenues and expenditures (current and capital) per capita across jurisdictions? What are the differences in terms of own-source revenues and total revenues?

Have these disparities increased or decreased over the recent past? Is there any information on disparities within tiers of government?

- Are there any measures of fiscal capacity, i.e., tax bases, as opposed to simply revenue collections? Is there any information on total taxes collected (including central government taxes) across regions? (The latter may be a proxy for differences in tax capacity.)

MACRO-ECONOMIC STABILITY

There is full consensus in the literature that the responsibility for macro-economic stability should be retained by central governments. One normal concern about macro stability is that central governments lose the power to stabilize when too much spending and taxing ability has been delegated to the localities. The loss of stabilization tools is considered a negative consequence of FD. This loss of ability to stabilize macro-economic disturbances and pursue structural adjustment is the main concern that economists have about fiscal decentralization. (See Tanzi, 1995; Ahmad, et. al., 1995; Prud'homme, 1995) For this reason, the results of FD depend to an important degree on functioning of LGU internal fiscal management controls as outlined above in Section Three. For a review of macroeconomic management problems and solutions in a number of countries see Roy (1995). Research has shown, and the consensus among economists is, that macro economic stability is an important condition for economic growth. By addressing this issue we are again addressing the growth connection specified in the scope of work. The most serious threat to macroeconomic stability within the context of FD design is when subnational governments are allowed to borrow too freely. If this leads to financially irresponsible behavior, the central government can be forced to take over subnational debt, thereby destabilizing the central government budget. Inflationary finance via increases in the money supply is the ultimate negative outcome of this type of scenario. The recent experiences of Argentina with subnational borrowing has become a paradigm on how not to design FD. Regional and local governments were allowed to borrow from regionally-owned banks which in turn had direct borrowing privileges with the central bank. To keep the power to stabilize the macro-economy at the central government level certain conditions are necessary.

Rule: Balanced budgets should be required at the local level. Local governments should feel a "hard" budget constraint and perceive that there can be no "bail out" available from the central government. There should be no record of the central government "bailing out" big or irresponsible spenders.

Rule: Borrowing by local governments should be limited. Furthermore, there should be no monetization of local debt. If borrowing at the local level is allowed, it should be limited to capital expenditures. Borrowing should not be exclusively, and if possible not at all from state-owned or controlled banks that pass along subsidized rates and terms. Questions to be asked are, Who controls subnational government borrowing? What institutional controls exist (e.g.. Is prior approval of the Ministry of Finance required? Is there some obligatory registration?, etc.)

Rule: Budget amendments should be limited. Once budgets are established, and revenues assigned there should be very limited LGU ability to increase them through approval of supplemental requests.

Rule: Tax levers for pursuing macro-stability should be retained by the central government. For example, most control over the tax rates and base for the personal income tax should be retained by the central government. Furthermore, the automatic stabilizing features of the personal income tax (and others) should be retained.

Rule: Significant taxation and expenditure responsibility should be retained by the central government. If all responsibility is turned over to local governments, the central government loses leverage to pursue stabilization.

Application or failure to apply these rules can be illustrated by the cases of Poland, Albania and Brazil. By applying the rules, Poland has moved to support FD. By failing to attend to macro stabilization Albania has weakened FD. Brazil's case is one of the central government giving up some stabilization powers, stimulating FD, but at the expense of stability.

In the early 1990s, Poland introduced shock therapy to control budget deficits, reduce inflation, privatize of SOEs, increase private sector GDP, stimulate foreign investment and hence encourage strong growth. Stabilization and tight fiscal policies included efforts to reform the efficiency of the state and downsize the scope of the central government. Simultaneously, controls were applied over local budgetary balances and financing authority to prevent treasury responsibilities arising from LGU arrears and debts. The 1990 Law on Local Self-Government allowed short-term bank for liquidity management, not to exceed 5% of past year expenditures. It also allowed longer-term loans to finance investments, with interest and principal not to exceed 5% of expenditures (Barbone and Hicks, 1995:161). The central government retained responsibility for the bases, rates and collections of corporate and income taxes, but delegated responsibilities to LGUs (gmina) for local fees and property taxes. The result has been macroeconomic stability, emergence of a strong, autonomous local government, few local deficit pressures on central macroeconomic stability (1995:166), and one of the highest growth rates in Eastern Europe. The experience of Poland is repeated in other EE transition economies such as Estonia and Latvia.

Lack of vigilance on macroeconomic stabilization is associated with negative consequences for both FD and growth in Albania. Following Polish-style shock therapy in 1991 which reduced budget deficits, cut inflation and halted subsidized credits to inefficient SOEs, it became clear that fiscal leakages still existed. Private savings and some public funds had been invested in "pyramid" or "ponzi"schemes that were effectively exempt from MOF controls. Revenue collections also began to diminish in 1996 and central fiscal deficits began to grow. At the same time, recentralization of local finances continued. The central treasury controlled local expenditures and MOF district offices collected most local taxes. Tight control of local finances was combined with loose control of central finances. Fearing further erosion of central expenditure control, parliament and the central government continue to withhold most assignments of revenue, expenditure and functional authority. But LGU services continue to be high cost and low coverage. In two emergency areas, the central government delegated authority that, given treasury controls over LGU balances, produced favorable results. Social assistance and school maintenance administrative functions were delegated to LGUs, with funding covered by central transfers. In these areas, costs of services decreased and coverage has increased. One lesson from Albania is that central failure to prevent macroeconomic instability removed incentives to proceed with further FD reforms that could reduce pressures on macroeconomic stability by decreasing program and service delivery costs. Albania's experience has been repeated to a large extent in other EE countries in transition with a poor macroeconomic stability record such as Bulgaria and Romania.

Brazil represents an extreme case of inadequate macroeconomic controls at the subnational level over LGUs that has been termed "laissez-faire decentralization." Historically, municipios have had almost complete revenue and expenditure autonomy. Municipalities even receive a 20% earmarked share of the state VAT with no restrictions on use of these revenues. There are no hard budget constraints on local governments and the central treasury has been responsible for billions in local loan defaults. In addition, intergovernmental responsibilities have not been assigned, leading to bargaining among elected officials of states and localities to shift burdens and obscure accountability relationships with constituents (World Bank, 1995:43). Brazil is a solid example of how lack of control over local finances can weaken national efforts to achieve macroeconomic stability.

REGIONAL COMPETITION

A common concern is that in competing with one another, local governments may lose some of the advantages that they originally gained by FD. Subnational and regional governments may grant local tax breaks in attempts to attract investment, and of course will always compete for revenues available from the central government. This may have positive or negative results depending on the outcome. FD will provide an incentive to local authorities to compete on the basis of the quality of local goods and services combined with reasonable taxation. On the other hand, competition may induce local governments to overly commit themselves and lead to borrowing and deficit spending. Competition among subnational governments may also lead to a run-for-the- bottom on tax burdens, thus threatening the provision of basic services. Competition among subnational governments can also turn into a negative-sum game with predatory policies and attempts to export local tax burdens to other jurisdictions. Questions generally revolve around how much discretion is allowed local governments in altering the fiscal conditions existing within their jurisdiction.

Most countries assign subnational governments the legal authority to grant fiscal incentives. While these include tax holidays, because rates and bases are centrally-set, LGUs can invest in roads, sewers and special amenities to induce investments and attract businesses. The evidence that has been gathered so far tends to show that competition for investment has been positive in that economic development and growth has been the result of improved infrastructure. While the projects (sewer lines, roads, water pipes) have been relatively small, they have provided jobs during construction and LGU management experience in project administration. Competition also appears to have a positive effect on the efficiency and effectiveness of local service delivery. With more local competition expenditures per capita tend to be lower and the quality of services improved. These effects have been measured for North America and Western Europe. Little evidence has yet been gathered in this respect for developing countries and EE countries in transition. However, elements of a negative-sum game are also present. Subnational governments in many countries grant incentives to businesses without any positive addition to business activity but which do affect the geographic location of those businesses.

Rule: Local capacity to grant fiscal incentives in the form of tax and fee exemptions should be limited to own-source revenues and perhaps shares of national taxes. Explicit limits should be placed on the type of competition to avoid run-to-the-bottom strategies. Regional and local governments should be encouraged to compete by providing better and cheaper services. Provision of supporting infrastructure investments related to private projects can be used as incentives by LGUs. But they should not be encouraged because they can easily result in negative-sum outcomes.

Questions that should be asked in the case studies include:

- How much of a recognized policy problem is regional competition at the national level? Are there very predominant centers of economic activity which are perceived as a threat to the development of other areas of the country?

- How much mobility exists across jurisdictions?

- How much discretion is allowed on the use of different taxes, from a general list of allowed subnational taxes?

- Is there discretion in setting tax rates for own taxes and shared taxes? Is there a maximum and minimum rate applied when there is some discretion in setting rates?

- How much discretion do subnational governments have in granting tax holidays and other "fiscal incentives" to individual taxpayers? Do these powers involve only subnational taxes or can shared taxes be affected? (Shared taxes are those taxes collected by the central government which are shared with the locality)

- Is there a habit of opaque or special deals granted by subnational authorities to business interests?

- How much budgetary discretion is there to vary the mix and level of public services?

SECTION FOUR
THE DEVOLUTION PROCESS

Efforts to program foreign assistance to maximize growth through FD strategies should recognize that the process of FD can take many forms. Because of the specific country roles of such factors as: size, history, level of development, evolution of intergovernmental governmental structures, differences in the clarity of political objectives, and local innovations, there is no "cookie-cutter" approach that can be applied across the board to all countries. While an FD formula does not exist, general guidelines can be provided that could be tested and refined in case studies. It is the objective of this section to illustrate that while the process of FD may differ from country to country, the main elements that drive the process are the ones that have already been discussed in Section Three. Furthermore, priorities for guiding the process can be identified and a sequence of events suggested.

In Section Three, we suggested that case studies examine four simultaneously occurring economic dimensions associated with FD. A logical question prior to designing programs of policy intervention is: in what sequence should measures (rules and mechanisms) be used to maximize the benefits of FD recognizing that there are also costs associated with each? Based on the rules and mechanisms provided above, external assistance for FD may require the recommendation of different sequences than those that have been or are being followed in actual cases. Viewing FD as a process permits us to focus on workable solutions to what may be common crises and challenges facing governments. The devolution process refers to the sequence employed by government regimes in first deconcentrating, or delegating, and eventually devolving fiscal authority to LGUs. Actual policies in different countries reflect differences in values, history, demographics, perceptions of current threats to sovereignty and reactions to external forces including donors and neighboring states. Perceptions of whether FD carries political costs (e.g. encouraging destruction of unitary nation-states by regional separatists) and benefits (e.g. enhancement of social benefits which strengthen local political bases) necessarily will vary from country to country and even in the same country over time. Government policies are a reflection of political history and current power rivalries.

An important contribution of technical assistance would be to provide guidance to governments on the optimal sequence for FD. This is a question that has not received much attention in the FD literature. Further research is needed on the optimal sequencing strategies and the dynamics of regime policies that may facilitate or impede FD. Nevertheless, experience suggests that to maximize the benefits of FD, the devolution process should treat four institutional and policy issues in order: (1) macroeconomic stability, (2) establishment of local fiscal discipline and improvements in internal management, (3) assignment of responsibilities and revenue sources to tiers of government, and (4) development of institutional mechanisms to ensure horizontal balance across LGUs.

1. **Macroeconomic stabilization.** There is widespread consensus that without stable prices, employment and relatively balanced government budgets, all other institutions and policies including FD can easily be destroyed. The primacy of macroeconomic stabilization has been driven by IMF, World Bank, USAID and other international organizations lending technical assistance to developing countries and EE countries in transition. Macroeconomic stability ensures political stability and attracts foreign financing and investments needed for job creation in the private sector and infrastructure development in the public sector. However, the priority of macroeconomic stabilization does not mean that other economic dimensions can be ignored. For example, external and regime failure to deal with institutional efficiency and regional inequity issues adversely affected effective macroeconomic stabilization in the former Yugoslavia. Further, there is the risk of superficially meeting donor budget targets without making the necessary difficult choices. Postponing hard decisions leads to hidden future deficits and harder choices . For instance, Russia and the Ukraine early in the transition lacked the institutional controls necessary to prevent the approval of budgets based on low inflation

forecasts and overly optimistic revenue collections. But in order to preserve macroeconomic stabilization targets these countries have been forced to take disruptive measures such as reducing outlays artificially by running up arrears on wages and pensions.

Also, as noted in Section Three, governments may employ accounting gimmickery to meet macroeconomic limits. Where governments hide outlays in off-budget accounts, they may be controlling only part of public expenditures which will lead to fiscal instability later. This has been a common problem in Russia and the former Soviet republics. Finally, devolution of expenditure authority can complicate counter-cyclical fiscal policy and pose macroeconomic management problems as it has in the Philippines (Miller, 1996:13). Governments need to know how to coordinate macroeconomic strategies by stimulating institutional efficiency and reducing regional inequities.

2. **Local budgetary and fiscal management efficiency.** After, ensuring sustainable macroeconomic reforms, an FD strategy needs to focus on budget reforms, including proper budget classification, a rigorous formulation and approval calendar and new forecasting techniques. Process reforms should also include budget execution institutions with treasury controls over local expenditures in the form of regular accounting and reporting requirements and limits on borrowing. Institutions should be strengthened for internal and external audit and budget evaluation. Good budget process and fiscal management institutions will guarantee that FD does not become a threat to the overriding objective of macroeconomic stability. In the early stages of FD, it may be necessary to maintain control over subnational government expenditures, including the reporting of budget expenditures and revenues directly from local governments to district offices of the central MOF/Treasury. The most effective medium-term vehicle for improving local financial management is to design and install integrated financial management systems that link procurement, budgeting, accounting, internal control, and treasury management functions into one organizational information system. This provides information to central treasuries for fiscal control and to local officials for setting and implementing programs.

Field experience suggests that the incentives for local officials to utilize technical assistance in this area and to make local finance transactions more transparent lie in delegating increased authority to raise revenues and to determine the composition of local expenditures.

Democratic institutions are also necessary conditions for effective FD. This means that at a minimum LGU officials are elected into and out of office by their constituencies. Since many of the choices faced by LGU officials involve finance, in addition to skills and systems in fiscal management, institutions are needed to aggregate popular demands on fiscal choices which can also be used to hold officials accountable. Without accountability to local taxpayers the efficiency gains associated with FD cannot arise.

A strategy of FD also needs to answer the question of how many tiers of government or what should be the vertical structure of a decentralized system of government? Should there be a two-tier system with a central and local government? Or should there be an intermediate level of government? The guidance offered by public finance theory to these questions is very similar to that offered by the principles of expenditure assignment. An intermediate level of government is desirable if there are services with spillovers across many LGUs but not enough to cover the national territory. Naturally, an important determinant of this choice is the size of the national territory. But, as will be argued in Section Five, in the end it would appear that tradition and history have been more influential on the choice of vertical structures than any technical considerations. For example, the three Baltic countries of Estonia, Latvia and Lithuania have made entirely different decisions since independence from the Former Soviet union on their vertical structures of government (Martinez-Vazquez and Boex, 1995b)

3. **Assignment of expenditures and revenues.** Once macroeconomic stability is ensured, subnational governments have the proper budgeting and fiscal management institutions to guarantee the efficient use of

resources and the necessary democratic institutions in place, an FD strategy can get down to the business of proper FD design. The first issue in that design should always be which level of government will deliver which services? Then, what level and kind of financing is implied? (Bahl and Wallich, 1994:327). In reality, decisions on these two assignments must often be made simultaneously. To achieve efficient FD, services cannot simply be devolved to the lowest or smallest unit in the intergovernmental structure. Absolute subnational autonomy has never been a goal even in federal systems of government (Shah, 1994:40). Economies of scale, type of service, political proximity, and benefit areas need to be considered in each case. At the top of the list for immediate devolution are those services that have impacts locally with few spillovers or economies of scale, and for which political proximity is important (Shah, 1994:14). Sanitation, police, fire, primary education, street maintenance, local transit, traffic management, and some law enforcement are all possible candidates. Of these, assignment of power to rationalize local property rights (titles, assessments) and enforce contracts and local laws (police powers) are probably most important to ensuring substantive FD.

Based on balances between economies of scale and administrative convenience a priority list of service devolution can be proposed. Latin American regimes are now facing a political backlash from successful macroeconomic reforms that have reduced the percentage of population living in poverty but have not materially improved the efficiency of basic local services such as law enforcement. Some regimes have responded to a popular definition of the issue as being a tradeoff between democracy and efficiency by questioning commitment to democracy (*Economist*, November 30, 1996:21). Others more sensibly view this as a false choice and have focused on the issue of proper mechanisms to ensure subnational service delivery (law, order, water, sewerage, transit). This means attention to economies of scale in assignments and sensitivity to vertical imbalances at each level of government. Latin American regimes in general have not done this. Instead they have focused more on macroeconomic stabilization and assigning shares of central powers and resources to LGUs without paying much attention to increasing the quality of the budget process and clearly assigning expenditure responsibilities.

Next on the list would be those services with some degree of scale economies, where benefit spillovers are not serious and proximity to people is important. Examples are in areas of: land use planning, secondary education, water and sewerage, refuse disposal, water supply, air-water pollution control, and area-wide road maintenance. In order to maximize welfare gains through FD, decision-making control should correspond to benefit jurisdictions where final mixes of such services can be varied according to local preferences.

In the case of this class of services, assignments should be made to such subnational units as metropolitan governments, special purpose districts, regional governments, or prefects. Central governments should assign discretion to LGUs sufficient to develop the proper mix of intergovernmental coordinating mechanisms to serve the public welfare by providing better services. Because many such services cross jurisdictional boundaries and fall between levels of government, flexibility is needed to redesign service delivery arrangements. Such mechanisms include: intergovernmental service agreements, confederation, privatization or contracting-out services, special purpose authorities and metropolitan government (Guess, 1996). Since many of these intermediate level services involve capital planning and financing, central governments also must work with subunits having minimal administrative expertise but which need to finance local works. In EE countries in transition, central planning and financing of capital expenditure was riddled with technical and allocative inefficiencies. This system would need to be replaced in stages with: capital transfers by formula, privatization of utilities, and giving authority to contract out and finance on a pay-as-you-go basis with contractors, capital loans from central donor-fed funds, and finally financing through borrowing from intermediaries and issuance of bonds in a capital market. As emphasized before, it is important to keep tight controls over LGU borrowing powers until capital markets develop.

Finally, where there are major spillovers, services can remain centrally-provided and financed (e.g. defense) or if local proximity is required (e.g. social assistance payments) can remain centrally financed and locally provided (or deconcentrated) without major violations of economies of scale rules. Violations of economic rules that dictate FD in these areas have been due mainly to regime perceptions of political risk to its majority control, threats to national sovereignty where separatist issues are important, or misunderstanding of the meaning of economies of scale and spillovers. For example, central governments may push their own deficits down by shifting unfunded expenditure responsibilities to subnational levels hoping they will cut costs (Martinez-Vazquez, 1994b). In early stages of the transition, this was a common occurrence in the Russian Federation.

In some cases, because of the need for proximity to constituents and political benefits to officials, the most effective assignment pattern may not be the least cost approach. It may be more politically useful to move decisions closer to users when economies of scale would dictate otherwise. Optimal assignments based on subsidiarity to districts whose boundaries incorporate intended beneficiaries may clash in some cases with the need to be accountable to mixes of central authorities and local constituents. This is a complex intergovernmental design issue. For example, faced with administrative incapacities that prevent efficient service delivery, Peruvian authorities are utilizing NGOs that may be more responsive (World Bank, 1995:31) and therefore politically beneficial. Similarly, the social investment funds promoted by World Bank in countries such as Bolivia and Honduras have sacrificed the objective of strengthening local government institutions and instead have opted for more expedient and effective parallel organizations at the local level.

Regarding the assignment of revenue sources to LGUs the first decision concerns the level of funding that will come from own-revenue sources vis-a-vis revenue-sharing and central government transfers. There is no exact rule to be applied here. However, the larger the share of local expenditure financed from own-revenue sources, the greater the accountability and efficiency of LGU expenditures. The level and type of revenue sources assigned to LGUs need to give them enough flexibility to increase expenditures if they so desire.

The optimal revenue sources to be assigned to local government are those that allow for a benefit principle or correspondence between what taxpayers pay and services they receive. In addition, these revenue sources should not be easily exportable outside the jurisdiction. Thus, at the top of the list of candidates for revenue assignment are user fee and charges and betterment levies. These are consistently underutilized in developing countries and in transition economies. Among taxes, the best candidates for assignment at the local level are property taxes and an individual income tax.The latter can be used as a surcharge on a national income tax. The use of local income taxes should not lead to the elimination of an income tax at the national level because of the effectiveness of this tax for the central government redistribution function. Other taxes that can be assigned at the local level include a retail sales tax and excises. However, these taxes can be problematic in how they are implemented. In particular, the sales tax can lead to cascading effects and interact poorly with a national VAT.

If revenue sharing of particular taxes on a derivation basis is chosen or a funding arrangement for LGUs, special care should be given to exclude the VAT from the list of shareable taxes. Corporate income taxes can be shared but their fair distribution will require the implementation of formulae and complex rules. It also needs to be remembered that revenue sharing arrangements are not substitutes for genuine local revenue autonomy. Under revenue sharing arrangements, LGUs have no discretion over rates (or bases) and therefore they will lack the ability to increase their resources.

4. **Ensure Regional (Horizontal) Balance.** The design of FD must also deal with major differences in capacities to finance services. Where LGUs levy the same taxes, differences in capacity mean that they cannot afford to provide some services, and that they may well provide less or lower quality services. All countries, rich or poor, developing or in transition, tend to show large disparities in fiscal capacity across region. For example, the differences between top and bottom Philippine LGUs on per capita own source revenues is 80

times (Miller, 1996:11). To reduce regional disparities in services caused by income inequality, central governments most often design transfers based on equalization formulae. These formulae include measures of relative need and measures of fiscal capacity. Measures of need are necessary because LGUs with identical fiscal capacities will be in quite different positions if they differ in costs of providing standardized services (such as the northern regions of Russia) or differ in population groups that are more vulnerable (the young and elderly). The trick in the design of the formula is to encourage local revenue mobilization without encouraging major dependencies on transfers that can destroy incentives for efficiency.

The incorporation of fiscal capacity differences in the transfer formula requires good data on tax bases at the local level. Such data, however, is generally lacking in developing countries and transition economies. Nevertheless, more readily available measures such as per capita income or poverty measures such as infant mortality rates can often be used as substitutes for fiscal capacity. It is important to avoid using own-revenue collections as a measure of fiscal capacity in equalization formulae.

SECTION FIVE
HISTORICAL AND INSTITUTIONAL ENVIRONMENT

Features of a particular country's institutional history are likely to affect the applicability and effectiveness of the rules and institutional mechanisms proposed in this methodology. Given national experiences with government formation and reform, case studies would benefit form a brief roadmap of salient factors (often referred to as "political culture") likely to affect technical assistance programs. The general question is how will institutional history affect the propensity of regimes and states to apply the economic rules and institutional mechanisms provided in this methodology?

It can be surmised that the effects of institutional history will influence efforts to change official and institutional behavior relevant to FD. For example, cultural and historic factors will likely have greater influence over broader policy changes (e.g. eliminate SOE subsidies from the budget for improved macroeconomic stability) than over narrower technical changes (e.g. change LGU budget and accounting codes for improved reporting). Thus, in broader policy changes (e.g. devolution and delegation of functions) one may expect political culture to exert positive and negative influences. The purpose of this section is to outline potential historic and institutional influences by blocs of countries in the areas of (1) assignment of authority to lower tiers of government, (2) financial management process, and (3) legal basis of public management. Like the specification of a "devolution process," institutional history has many facets which have been evolving through time and cannot be easily synthesized into a set of current determinants. But broader, perhaps still useful, generalizations can be made. In order to cover the widest number of countries, it may be helpful to examine those core systems that had significant influences over other countries. For this purpose, institutional history generalizations from these former colonial blocs and spheres of influence blocs can be considered: (1) French, (2) Iberian, (3) US, (4) British, and (5) Former Soviet Union.

FRENCH SYSTEMS

Assignment of Authority

The French context is that of a state-created nation with strong treasury influence over central and local fiscal and policy direction. States under the historical influence of the French system (Africa, and Eastern European states with French-speaking elites such as Bulgaria and Albania) often function consistently with principles behind this institutional model. The French model of strong central state has influenced several states to deconcentrate services rather than devolve control to local units; or to retain control at the center.

Financial Management Process

The French financial management system is based on two principles: strong financial control and a central treasury (Premchand, 1983:133). Fiscal controls are exercised by cadre of ministry comptrollers, public accountants, and powerful financial inspectors. The treasury functions as a cashier and a banker. Control and treasury functions are deconcentrated to subnational units so that local authorities are integrated into the national system. Of late, to achieve FD efficiencies, greater authority has been devolved to local units.

Legal Basis of Public Management

The French legal system (the Napoleonic civil code tradition) attempts to codify public decisions and tends to work against the US tradition of management autonomy. The French legal system is similar in management function to the Spanish code--both operate to some extent as constraints to increases in public sector productivity by increasing the perceived risk of making an erroneous and possibly illegal decision.

IBERIAN SYSTEMS

Assignment of Authority

The Iberian-Spanish influence over Latin American governmental structures and processes remains strong. The Spanish centralist tradition created governments throughout Latin America with central government control over the country. Intermediate administrative layers represented arms of the central government rather than autonomous tiers of government in a federal system. The centralist tradition produced either unitary-style systems or strong reactions to authoritarian centralism as exemplified by the “laissez-faire” decentralization in Brazil. In the Brazilian federal system, central influence over local priorities is limited. By contrast, in Mexico, which is also a federal system, the influence of the central government is very strong (Shah, 1994:6).

The Iberian centralist tradition can be reversed or mitigated by changes in colonial masters or evidence of economic benefits outweighing political costs. In the Philippines, the US colonial system restored the local role in government that had been eliminated under the rigidly centralized political authority of Spanish influence (Miller, 1996:6). Centralist controls can be mitigated by institutional quid pro quos without encountering major cultural constraints.. For example, to speed up budget releases the Ecuadorian MOF reduced multiple steps for pay order approvals in 1989 in exchange for greater post-audit reporting requirements. The experience of learning and performing novel but narrower technical tasks can make incremental changes in routine that lead to cultural adaptation and change (Guess, 1992). Latin American local governments still lack discretion to decide which programs to apply funds, (i.e. devolution). But in the past decade, Latin American states have delegated many functions to municipalities to serve as agents for the central government in program administration (Lopez Murphy, 1995: 31). Of late, Spain has adopted a highly decentralized system, devolving expenditure and taxing powers to two regions. Although Spain still has a unitary system of government, many of its features are similar to those in federal systems.

Financial Management Process

Latin American budgetary systems have evolved from Iberian influence partly from their own administrative experiences. The major features of Latin American budgetary systems have been: extensive earmarking of funds and deconcentration of government activities into autonomous agencies (Premchand, 1983:134). Budgets are narrow in coverage meaning that fiscal deficits may not measure operations of the consolidated public sector. This has inhibited central macroeconomic planning and expenditure monitoring and control, and explains some of the more serious fiscal policy problems with which Latin American states have had to grapple.

Legal Basis of Public Management

Institutional change and assumption of management responsibilities have been inhibited by the formalistic tradition of the legal codes which attempt to codify public decision-making. The tendency of management to await specific orders from higher authority before taking action is a direct product of this legal tradition (and is similar to the legal environment faced for years by socialist officials). Where a tight vertical command structure governs official action at the expense of program efficiencies, risk-taking and innovation are inhibited.

UNITED STATES

Assignment of Authority

Governmental structure consists of constitutionally-based delegations of substantial authority to states. States delegate authority to local governments. States can choose their own tax structures so long as they do not violate the Constitution which outlaw levies that interfere with interstate commerce or that discriminate against subgroups in the population. Each tier of government has its own budget. But budgets are related through networks of intergovernmental transfers. State and local recurrent budgets must be balanced. Borrowing is officially allowed for capital purposes only. The US government receives most of its revenues from income taxation; the states from sales and income taxes; and municipalities from property taxes and state transfers (Bahl, 1995:77). The level of budgetary autonomy and taxing powers of LGUs in the U.S. are for the most part unmatched in the world. This makes the U.S. a special case.

Financial Management Process

The U.S. local government budgeting model is heavily oriented towards management discretion and away from legal restrictions on operations. Budgets are prepared and approved according to matches between revenue authority and expenditure needs. Budget items are not legally coded; accounting and budget codes can be changed for purposes of improved management without legal decisions; expenditure authority is granted by the council and exercised by managers subject only to internal and external controls. Emphasis is also on post-facto responsibility for expenditures through audits rather than pre-control of each transaction (as is common in Latin America) by ministry accountants that can delay service delivery and drive up costs of investment projects.

Legal Basis of Public Management

U.S. LGU managers have considerable discretion based upon broad grants of legal authority. LGU units formulate budgets without specific reference to legal codes. Formats and budget structures can change within the context of potentially adverse judgment by financial markets and auditors on transparency criteria. Accounting codes can be changed within the same broad framework. Managers implement budgets within council-approved budget limits and are subject to discipline depending upon budget resolution language on overspending items and totals. Reasonableness of managerial discretion can be the subject of cases brought before independent administrative law tribunals.

GREAT BRITAIN

Assignment of Authority

In the British model, delegation of power has evolved over the years in a way that has blurred accountability. The Westminister model consists of a very centralized unitary state, a vague constitution that is very adaptable but can easily be manipulated, an executive that dominates Parliament, and an ethos of Treasury dominance of the Whitehall bureaucracy (Whiteley, 1996:945). Emphasis on the cabinet-parliament form of government within the framework of common law has influenced the design and functioning of "Commonwealth" nations across continents from Australia, to America (Belize) and Africa (Ghana). In this context, local governments are integrated into the central government structure and are provided with substantial levels of transfers to cover local constituent needs. This balances treasury preferences for expenditure control with local authority preferences for autonomy.

Financial Management Process

The budget law establishes a central consolidated fund through which all revenues and expenditures flow. In the U.K. model, budgeting focuses mainly on the expenditure side, and spending agencies are subject to different degrees of control during budget execution (Premchand, 1984:133). Cash limits were introduced in the 1970s as an instrument of budget control and they indicate in advance the maximum amounts to be spent by line agencies on blocks of services. Cash limits incorporate prespecified amounts for inflation and indicate that some purchases are to be cut if prices exceed the limits. The limits extended to fiscal transfers to local governments. In the UK, about 80 percent of local government revenues flow from the central government in grants. Even though local governments provide only 20 percent of their own revenue, the UK is considered decentralized by many observers. Because of substantial revenues from transfers (which eliminate most of the vertical imbalance), U.K. local governments spend the second highest share of total public sector expenditures among OECD countries (World Bank, 1995:38).

The U.K. budget model uses a multi-year expenditure planning and control framework. The Public Expenditure Survey (PES) of the 1970s created a framework for: analysis of expenditures within functional groups, provision of revenue and expenditure estimates on a constant basis (ensuring that agencies and local governments would be funded in real terms), and budgeting through annual budgets made part of rolling multiyear plans. High inflation weakened this framework and cash limits replaced the PES in the 1980s (Axelrod, 1988:279)

FORMER SOVIET SYSTEM

This is the largest of centrally planned systems in transition. Assistance programs need to take in to account the extraordinary political and ethnic diversity of the Russian Federation. The challenge is to build effective institutions for intergovernmental relations, budgetary management and economic stabilization within the historical context of a society that lacks a civil society tradition (Hoffman, 1996:A1).

The system of intergovernmental relations in the Former Soviet Union (FSU) had a profound effect on FD systems that emerged with its breakup. For many years during the transition, the Russian Federation continued to use the same framework and approaches that were used in the Soviet Union. This was also the case with most of the former Soviet Republics including Ukraine and Kazakstan. The only break with the old system took place in the Baltic countries (Martinez-Vazquez and Boex, 1995b).

The Soviet system of intergovernmental finance was de jure a highly decentralized system. But de facto the system operated more like a centralized unitarian system than a decentralized federal system.

Assignment of Authority

The legal framework provided each level of government with significant freedom to formulate their budget and even raise their own revenues. In practice, all decisions were made at the center. The only agency with ultimate decision power was Gosplan (The Ministry of Planning and Economy). Even the role of the MOF was secondary. The system was pervaded by "dual subordination" which meant that LGU officials (at the republic, regional (oblast) and local (rayon and city) levels had to respond not only to their government but also all the way to the top in Moscow.

However, because of the vastness and diversity of the system, it was hard for the center to exert close range control of subnational government activities. The authority of the central authorities was based more on legal instructions on the use of thousands of budgetary items for public expenditures, than on the ability to control or receive information from subordinate units. This lack of control was evidenced by the fact that what ultimately led to the breakdown of the FSU was the refusal of the republic governments to transfer up tax revenues that supposedly belonged to the Federation.

Financial Management Process

The main feature of the budgeting process under the Soviet Union was a model of the "nested " budgets which had been associated with the image of Matrushka dolls, a popular folklore item in Russia. Like dolls hiding smaller dolls within, the budget of the Federation contained all consolidated budgets of the republics. The latter in turn contained the consolidated budgets of the regions (oblasts). And the budgets of the regions contained the budgets of the lowest tier of government, rayons which are similar to counties, and the gorads (or cities). The budget process was informed by a fairly detailed assignment of expenditure responsibilities for the four tiers of government and by an extremely detailed set of budgetary "norms" or standards on how public services at each level should be provided (e.g. roubles/meal/type of hospital/type of patient). The assignment of expenditure responsibilities was roughly consistent with the general principles of expenditure assignment reflecting benefit areas and the possibility of economies of scale in production. However, this assignment was not linked with any significant degree of budgetary autonomy. Budgets were formed according to a vertically hierarchical process and had to be based on centrally-set budget norms. Even though the norms were supposed to represent minimum standards of service, they in fact represented budget ceilings (Martinez-Vazquez, 1994b).

The assignment of revenue sources and the determinations of transfers (or subventions) took considerable effort and negotiation through successive interactions among the four tiers of government. But in reality the only purpose of these negotiations was to provide enough funding to cover the minimum expenditure budget determined through application of the norms. Thus, the negotiated budget process was about the size of the minimum expenditure budgets. These negotiations always took place in the hierarchical fashion implied by the "nested" budgets. For example, rayon and city officials negotiated only with regional or oblast officials and after the federation, republican and oblast budgets were already approved.

Even though all levels of government had been assigned their own sources, the most important source of funding was the sharing of national taxes. The sharing rates were "regulated" and adjusted on a customized basis so that funding would not exceed the minimum required expenditure budget set by the norms. In those cases where even total sharing of taxes was insufficient to cover the minimum expenditure budgets, republics, oblasts or rayons received a subvention or block grant. The end result of this financial management process was a crazy quilt of different sharing rules and subventions in a negotiated process that favored officials with more power and access. The distribution of public resources however, was only partially determined by the budget. Considerable levels of public services (from kindergartens and health clinics to roads and heating plants) were provided outside the budget by state enterprises. The location and resources of each enterprise were determined by Gosplan.

This financial management process is largely operational in most of the former Soviet republics. In some of the former republics there improvements and innovations have been introduced. For example, in Russia revenue sharing rates between the federation and the regions are now uniform and part of the equalization transfers are implemented through a formula. However, the basic concept of determining a minimum expenditure budget and filling the funding gap with revenue sharing and subventions still persists. In Russia, intergovernmental relations between the 89 regions and the local governments within each region still replicates the old Soviet model. This is also the case for most of the Central Asian republics and those in the Caucasus, Ukraine and Belarus.

SECTION SIX
COMPARATIVE ANALYSIS

The comparison of FD cases would be a useful activity from which to draw lessons on best practices and to avoid mechanisms that do not work. Having asked similar questions in case study countries on the four major issue areas described above, comparisons should be possible. However, comparisons cannot often be made by simple data observations. (e.g.. whether a country grew faster than another may not be a useful point of comparison.) Historical and institutional constraints become important and the "other" factors influencing growth and development may swamp the influence of FD. Also, in that FD is a multifaceted concept, it would be a mistake to draw fixed conclusions from one or only several dimensions.

Another useful product of cross-country comparisons is the study of policy responses of different countries when confronted with problems and opportunities. How were democratic institutions used and reinforced by FD? How did the government deal with regional inequality? Was macro stability threatened or constrained? Were there adverse effects from regional competition and if so what was done about it? Much can be learned if case studies use a standard methodology and set of questions. Hopefully the end result may be a sequence of generic technical assistance interventions that under expected behavior can lead a country through an effective devolution process yielding growth and development.

SECTION SEVEN
CONCLUSION AND RECOMMENDATIONS

In conclusion, we have proposed a case study methodology for analysis of FD. We suggest that what is important is how changes in FD affect changes in economic variables associated with economic development. Since it is the process by which FD affects other variables that is important to understand, we developed guidelines for case studies that can be used to explore the evolution of FD in developing and transitional countries and describe the ways that evolution has been linked to changes in economic development.

We have focussed our inquiry on four major economic characteristics, or dimensions of FD, each of which imply positive or negative outcomes from FD. The four dimensions are comprehensive in that they cover almost all major economic concerns with FD. Each of the dimensions is complex, and all come into play simultaneously in any consideration of FD policy. One cannot pursue fiscal decentralization without confronting these four factors. FD involves simultaneously occurring phenomena affecting economic efficiency, regional inequality, macroeconomic stability, and inter-regional competition that can have both positive and negative aspects. Our methodological approach focused on the application of appropriate fiscal rules and appropriate fiscal mechanisms for achieving the potential benefits of FD, while minimizing the likelihood of negative consequences.

In commissioning FD cases studies based on this methodology, USAID should consider the following in developing its scopes of work:

> First, countries vary in such factors as: size, historical influence on institutional development, social cohesion, and governmental values. To compare FD without controlling for these differences could lead to invalid policy prescriptions. In order to focus on FD in relationship to the economic dimensions and development, comparability in size and institutional influence should be considered. For example, size and historical and cultural influences are arguably similar enough in Estonia and Macedonia to allow focus on the comparative influences on FD and their effects on development.
>
> Second, cases should focus on how the economic dimensions and the devolution processes employed have affected FD. These will vary among otherwise comparable and similar countries. Case researchers should focus on the questions of how? and why?
>
> Third, observations should be made on how well the case has applied the rules and used the mechanisms suggested by our methodology. Based on questions proposed at the end of each section and by applying a fairly standard set of questions about rules and mechanisms, one can compare cases. One should be able to identify why some cases are more successful than others. From this one can identify probable reasons why a case has been particularly successful or why it has failed.
>
> Finally, in order to identify workable policy interventions by the host government and by USAID programs (which should include when to do nothing as well), by examining the application of rules and mechanisms, one may identify weaknesses in the FD process that may be amenable to policy changes.

NOTES

1. Preliminary tests of the relationship between FD and growth have been performed. The following references are illustrative:

Hamid, Davoodi and Heng-fu Zou (1996a) "Fiscal Decentralization and Economic Growth: a Cross-Country Study" (Washington, DC: World Bank). Findings: (1) in developed countries with three levels of government, FD (measured by share of public goods) enhances growth if central government is smaller and the state (regional or provincial governments) are larger and local are smaller. In developing countries with three levels of government, FD enhances growth if the central government is smaller because of a larger local government (and smaller regional governments), (2) in countries with two levels of government they find no statistically significant relationship between decentralization and growth depending upon the extent of decentralization.

Tao Zheng and Heng-fu Zou (1996) "Fiscal Decentralization, Public Spending and Economic Growth in China" (Washington, DC: World Bank). Finding: a higher degree of decentralization in China since the 1970s has been associated with lower provincial growth over the past 15 years in China. (The authors are surprised by the result because it contradicts expectation).

Oates, Wallace E. (1993) "Fiscal Decentralization and Economic Development" *National Tax Journal*, Volume 46, #2, pp.237-243. Oates (a major authority in the FD field) makes the conventional argument that more decentralized public expenditures should lead to more economic growth because decentralized spending will be more sensitive to regional and local conditions.

Hamid, Davoodi, Danyang Xie and Heng-fu Zou (1996b) "Fiscal Decentralization and Economic Growth in the U.S." (Washington, DC: World Bank). Finding: a higher degree of FD is associated with lower economic growth.

In conclusion, there are some preliminary tests of the relationship between FD and growth. The results are mixed. Further developments of theoretical links and statistical tools are needed.

2. For this study, we will generally confine our inquiry to four major economic characteristics, or dimensions of FD, each of which imply positive or negative outcomes from FD. These characteristics were discussed in our earlier "literature review" submitted to USAID on October 11, 1996.

BIBLIOGRAPHY

Ahmad, E., Ruiz, J.L. and Carrido, I. (1995). "Colombia: Endeudamiento Territorial, Gestion y Consideraciones Macroeconomicas," Washington, IMF.

Axelrod, Donald (1988). *Budgeting for Modern Government,* New York: St. Martin's Press.

Bahl, Roy and Wallich, Christine (1995). "Intergovernmental Fiscal Relations in the Russian Federation" in Bird, et al., op.cit, pp.69-119..

Bahl, Roy (1995). "Comparative Federalism: Trends and Issues in the United States, China and Russia" in Roy, op. cit., pp 73-103.

Bahl, R. (1994). "Revenues and Revenue Assignment: Intergovernmental Fiscal Relations in the Russian Federation," in Wallich, ed.

Bahl, R. And J. Linn (1992). *Urban Public Finance in Developing Countries*, NY: Oxford University Press.

Barbone, Luca and Hicks, James (1995). "Local and Intergovernmental Finances in Poland:An Evolving Agenda" in Bird et al., pp.153-183.

Bidus, Mark H. (1995). "Municipal Development and Democracy in Central America" (Guatemala: USAID/RHUDO).

Bird, (1994). "Decentralizing Infrastructure: For Good or for Ill," Policy Research Working Paper 1258, Washington, DC:World Bank.

Bird, R., R.E. Ebel and C. Wallich (eds.) (1994). *Decentralization of the Socialist State: Intergovernmental Finance in Transition Economies*, Washington, D.C.: The World Bank.

Breton, A. And Scott, A. (1978). *The Economic Constitution of Federal States,* Toronto: University of Toronto Press.

Broadway R., Roberts, S. and Shah, A. (1994). "The Reform of Fiscal Systems in Developing and Emerging Market Economies: A Federalism Perspective," Policy Research Working Paper 1259. Office of the Vice President, Development Economics, World Bank.

Caiden, Naomi and Wildavsky, Aaron (1975). *Planning and Budgeting in Poor Countries*, New York: Wiley.

Campbell, Timothy (1993). "Participation, Choice and Accountability in Local Government: Latin America," Washington, DC: World Bank (LACTD dissemination note).

Cremer, Estache and Seabright, (1994). "The Decentralization of Public Services: Lessons from the Theory of the Firm," Policy Research Working Paper 1345. Office of the Vice President, Development Economics, World Bank.

Davoodi, Hamid and Heng-fu Zou (1996a). "Fiscal Decentralization and Economic Growth: a Cross-Country Study," Washington, DC: World Bank.

__________ Danyang Xie and Heng-fu Zou (1996b). "Fiscal Decentralization and Economic Growth in the U.S.," Washington, DC: World Bank.

Ebel, Robert D. And Simon, Peter (1995). "Financing and Large Municipality: Budapest" in Bird, et al. (1995) op.cit., pp119-153.

The Economist (1996). "Latin America's Backlash" (November 30), p.15.

Ehdaie, (1994). "Fiscal Decentralization and the Size of Government: An Extension with Evidence from Cross-Country Data," Policy Research Working Paper 1387, Policy Research Department, Public Economics Division, World Bank.

Fiszbein, A. (1995). "Colombia Local Government Capacity: Beyond Technical Assistance," World Bank Report 14085-CO.

Guess, George M. (1996). "Coordinating Service Delivery in Federal Systems," Tirana: USAID Public Administration Program for Albania, 13 pp.

__________ (1992). "Centralization of Expenditure Controls in Latin America." *Public Administration Quarterly*, Volume 13, #3, pp.376-394.

Herzer (1992). "Local Governments in Argentina," INURD Working Paper 94. Transport, Water and Urban Development Department, Urban Development Division, World Bank.

Hoffman, David (1996). "Harsh History Stymies Civil Society." *The Washington Post*, A1.

Hunter, J.S.H. (1977). *Federalism and Fiscal Balance: a Comparative Study* (Canberra: Australian National University Press and Centre for Research on Federal Financial Relations).

Loehr, W. And Powelson, J.P. (1981). *The Economics of Development and Distribution*, New York, Harcourt, Brace Jovanovich.

Lopez Murphy, Ricardo (1995) (ed). *Fiscal Decentralization in Latin America,* Washington, DC:IADB.

Manor, J. (1996). "The Political Economy of Decentralization" (preliminary draft).

Martinez-Vazquez, Jorge (1995a). "Intergovernmental Fiscal Relations in Bulgaria" in Bird et al. (eds) pp.183-223.

__________ and Boex, Jamie (1995b). "Fiscal Decentralization in the Baltic Countries." *Proceedings of the National Tax Association* (San Diego).

__________ McClure, Claude E. and Wallace, Sally (1995c). "Fiscal Decentralization in the Ukraine" in Bird, et al.; (eds), pp.281-320.

__________ (1994a). "Expenditures and Expenditure Assignment" in Wallich ed. op. cit.

__________ (1994b). "The Challenge of Expenditure Assignment Reform in Russia." *Environment and Planning* (Volume 12).

McClure, C.E., Jr. (1995). "Comment on 'The Dangers of Decentralization' by Prud'homme." *Research Observer*, World Bank.

__________ Martinez-Vazquez, and Wallace, Sally (1997). *Fiscal Transition in Kazakhstan* (Manila: Asian Development Bank and Oxford University Press) (forthcoming).

Miller, T. (1996). "Fiscal Federalism in Theory and Practice: The Philippines Case," Draft of 06/12/96 USAID/G/EG/EIR.

Musgrave, R.A. (1959). *The Theory of Public Finance,* NY: McGraw-Hill.

Oates, W.E. (1993). "Fiscal Decentralization and Economic Development." *National Tax Journal*, Volume 46 #2, pp.237-243.

__________ (1972). *Fiscal Federalism*, NY: Harcourt, Brace Jovanovich.

Owens, J. And G. Panella (eds) (1991). *Local Governmental Finance: An International Perspective*, Amsterdam: North Holland.

Ostrom, Elinor (1965). "Public Entrepreneurship: A Case Study in Groundwater Management," Ph.D. Dissertation, (Los Angeles, UCLA).

__________ (1977) and Parks, Roger B., and Whitaker, Gordon P. "Policing Metropolitan America," Washington, DC: USGPO.

__________ (1992) and Schroeder, Larry and Wynne, S. *Institutional Incentives and Sustainable Development*, Boulder: Westview Press.

Peterson, G.E. (1996). "Decentralization in Latin America: Learning Through Experience," prepared for the World Bank (March).

Premchand, A. (1983). *Government Budgeting and Expenditure Controls: Theory and Practice*, Washington, DC:IMF.

Prud'homme, R. (1995). "The Dangers of Decentralization." *Research Observer*, World Bank.

Putnam, R.D. (1993). Making Democracy Work:Civic Traditions in Modern Italy, (Princeton, NJ, Princeton University Press.

Roy, Jayanta .(ed)(1995). *Macroeconomic Management and Fiscal Decentralization*, Washington DC: EDI Seminar Series, the World Bank.

Sanchez T., F. and Gutierrez, C. (1995). "Colombia," in Lopez Murphy, ed. op.cit.

Shah, A. (1991a). "Perspectives on the Design of Intergovernmental Relations," WPS 726, Country Economics Department, World Bank.

__________ (1991b). "The New Fiscal Federalism in Brazil," Discussion Paper 124, The World Bank.

__________ (1994). "The Reform of Intergovernmental Fiscal Relations in Developing and Emerging Market Economies," Policy and Research Series 23, The World Bank.

Spahn, Paul Bernd (1995). "China's Reform of Intergovernmental Fiscal Relations in the Light of European Experiences" in Roy (1995) op.cit., pp.125-162.

Tanzi, V. (1995). "Fiscal Federalism and Decentralization: A Review of Some Efficiency and Macroeconomic Aspects." *Annual World Bank Conference on Development Economics*, M. Bruno and B. Pleskovic, eds.

Taillant, J.D. (1994). "Decentralization: Local and Regional Government Development," LATPS, Draft (September 30).

Tao Zheng and Heng-fu Zou (1996). "Fiscal Decentralization, Public Spending and Economic Growth in China," Washington, DC: World Bank.

Wallich, C.I. Ed. (1994). *Russia and the Challenge of Fiscal Federalism,* World Bank.

Whiteley, Paul (1996). Review of The Treasury and Whitehall: The Planning and Control of Public Expenditure: 1976-1993 by Colin Thain and Maurice White (Oxford, Clarendon Press), *American Political Science Review*, Volume 90, #4, December 1996, pp945-946.

Wiesner, E. (1994). "Fiscal Decentralization and Social Spending in Latin America: The Search for Efficiency and Equity," Working Paper 199, the Inter-American Development Bank.

Wildasin, D.E. (1996). "Fiscal Aspects of Evolving Federations." *International Tax and Public Finance*, 3: 121-135.

Winkler, D.R. (1994). "The Design and Administration of Intergovernmental Transfers. Fiscal Decentralization in Latin America," Discussion Paper, The World Bank.

World Bank. (1990). "Argentina: Provincial Government Finance Study" Report 8176-AR, World Bank.

__________ (1995a). "Local Government Capacity in Colombia," A World Bank Country Study.

__________ (1995). "Better Urban Services: Finding the Right Incentives," Washington, DC:IBRD.